FEASIBILITY OF INTEREST-FREE BANKING
Experiments in Saudi Arabia and Egypt

THESIS SUBMITTED FOR THE DEGREE OF

Doctor of Philosophy

(Economics)

BY

Javed Ahmad Khan

Under the Supervision of

Professor Mahmudul Haq

CENTRE OF WEST ASIAN STUDIES
ALIGARH MUSLIM UNIVERSITY
ALIGARH (INDIA)
1988

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CENTRE OF WEST ASIAN STUDIES
ALIGARH MUSLIM UNIVERSITY
ALIGARH-202002 INDIA

29 September 1988

CERTIFICATE

This is to certify that the Ph.D thesis on Feasibility of Interest-Free Banking Experiments in Saudi Arabia and Egypt submitted by Mr. Javed Ahmad Khan under my supervision is his own original contribution and suitable for submission for the award of the degree of Ph.D.

Further certified that Mr. Javed Ahmad Khan has been engaged in full-time research and that he has put in required attendance as prescribed by the University.

(Prof. Mahmudul Haq)
Supervisor

C O N T E N T S

ACKNOWLEDGEMENT

I owe a debt of gratitude to a number of people for the completion of this thesis. Undertaking a controversial topic like this would not have been possible without both the moral and intellectual support of my supervisor Prof. Mahmudul Haq. I am also grateful to Prof. M.A.Saleem Khan, Director, Centre of West Asian Studies who helped me in so many ways. I wish to record my gratitude to Prof. M. Nejatullah Siddiqi for making me available some important materials on the subject. My thanks are especially due to Dr. Darwish S. Jastaneiah, Director, Centre for Research in Islamic Economics, Jeddah, who provided me with necessary materials. I will be failing in my duty if I did not express my thanks to Dr. A.A. Islahi for sending much of the necessary material from Saudi Arabia. My thanks are also due to Mr. M.S. Shaghil for his constructive comments on my thesis. I must express thanks to Library staff of West Asian Studies for their help and cooperation during the preparation of work. Mr. Ishtiaq Danish and Sabahuddin Azmi have done the painstaking work of proof reading and making intelligible remarks. I am also grateful to them. My deep appreciation is due to Mr. S.M. Ali who took special care in typing the thesis.

24 September 1988 JAVED AHMAD KHAN

I N T R O D U C T I O N

A dialogue on interest-free banking, generally known as "Islamic Banking", is going on in the world of Islam. It is a modern phenomenon and mainly a result of the crisis in the capitalist system. It has an appealing feature, particularly because of financial crisis around the world especially after the debt burden of the third world countries; as a result of which, there accrued a tendency of inflation followed by recession and then a large scale of unemployment. Ultimately there developed a growing gap between the resources necessary to finance and the revenues actually raised.

No doubt, huge oil income has played a crucial role in the development of Islamic banking. But its emergence in low income countries in south East Asia and Africa also speaks of its viability from religious point of view. Uptill now, around 47 Islamic finance institutions have been reported.

In recent times a good deal of literature have appeared on the subject written mainly by Muslim apologetics. An attempt is being made to develop a new study that could on the one hand, 'spell out an Islamic critique of modern economics and, on the other, to undertake a reformation of economic theory and policy in the light of Islamic values and principles. Professional economists are also taking interest in issues related to Islamic banking. These writers are trying to work out the monetary and fiscal 'policies' of Islam mainly through the institution of Zakah and the prohibition of riba i.e. interest - around which most of the contemporary literature on Islamic banking revolves.

However, in a number of Muslim countries, Islamic banking has been introduced - special banks operate on a non-interest basis. Countries like the Islamic Republic of Iran claims that the entire financial system is based on Islamic principles. It has rightly been pointed out that Muslim economists seemed to be so fascinated by all those ideas that appears to be good that they become 'Islamic' for them. For example, the objectives of monetary policy adopted by western economies do not appear un-Islamic for them. Almost every tool used in macro-economic analysis is also applied in Islamic economic system. This has brought a charge from the western press that Muslims have hastily reinterpretted their orthodox doctrine to adopt recent tendencies originating in the West.

There are many areas where disagreement persist's among Muslim economists. For example, the question whether creation of credit is allowed in shari'ah, since relationship of credit with interest is vital and a bank's credit supply is greatly influenced by the interest rates. Then question arises: how does Islamic bank do this job ? Muslim scholars in this matter object that commercial bank in the process of credit creation, create money for which neither the bank nor their depositors make any sacrifice. They argue that under present system the primary beneficiaries of credit creation are commercial banks and their customers. Other main areas of disagreements are: strategy of transition to Islamic economy, short-term financing, indexation of loans during inflation, stability of the economy and so on. All these and other issues have sparked among Islamic writers and also lead them to think on these lines. One wonders, how an interest-rate which is the cost of loans will disappear from credit market. Likewise, in an Islamic economy, how the rate of interest will be replaced by the rate of profit. The rate of profit, however, depends on the business conditions. Thus, the saving, investment decision in an Islamic economy would not depend on the rate of interest but only on the expectation about business prospects. How then the monetary policy will have any impact on the real sector of economy? I have tried to examine all these issues in the light of the current discussions that have appeared in the existing Islamic economic literature.

The basis of this thesis is on the fact that the Islamic concepts of interest-free banking system totally rejects the institution of interest. As a matter of fact, question of banking on Islamic principle, if we go through the earlier literature, had its origin in earlier muslim writers of the late

19th and early 20th century. In India, for example, Sayyid Ahmad Khan and in Egypt Muhammad 'Abduh raised these issues. The later works of Anwar Iqbal Qureshi and Abul A'la Mawdudi are worth mentioning. Qureshi, in his book Islam and the theory of interest (1945) points out that interest prevents the flow of capital towards project with a low yield even though they are most useful. He has argued that in the absenve of interest the margin of investment could be extended till the rate of return approaches zero. In his book he analysises the question of interest in the light of economic theory. In the book, he explained the western view-point about interest, exposed the weaker aspects of all the theories of interest. While discussing the origins of usury and interest he has elucidated the prohibition of banking system from Islamic stand point. He has also mentioned the reprucussions of profit and interest on human society. Another writer, Abul A'la Mawdudi, in his book 'Sūd' (1961) (originally written in Urdu and later on translated into English and Arabic), pointed out that a basic imbalance is caused between production and consumption by the phenomenon of interest. This happen in two ways. Firstly, interest on consumption loans transfers part of the purchasing power from a group of people with high propensity to consume to a group with low propensity to consume. This latter group mostly reinvest its income from interest which means that consumption demand is accompanied by an increase in production. Secondly, interest on productive loans raises the cost of production, hence the price of consumption goods. Once again the amount taxed away from the people, in the form of higher prices falls in the hands of a class with a lower than average propensity to consume. This imbalance is seen as the source of many evils such as stagnation and depression, monopoly and ultimately imperialism.

Another significant work on interest and banking is the Report of the Council of Islamic Idealogy. It was submitted to the Government of Pakistan in June 1980. The report contains a detailed blue print for reorganization of banking practices and and procedures on the basis of the principle of profit-loss-sharing in accordance with the Islamic legal concept of Shirkah and mudarabah. The methodology suggested in the report is modelled more or less on the same line as in the case of commer cial banks. The council of Islamic idealogy, however, recognise the difficulties in the elimination of interest from transactions relating to international loans and aids and has therefore, accept government borrowing from abroad on the basis of interest for the time being.

Among the recent important works on the subject includes; Issues in Islamic Banking by M.N. Siddiqi. This book in the form of collected essays, introduce the idea of a banking operation based on the Islamic principles of partnership and profit-sharing free of interest. It demonstrates how the creation of high powered money as well as of bank money in the Islamic system can be firmly linked. Comparing and contrasting the Islamic system with the interest-based banking system it shows the superiority of the formers on grounds of distributive justice, allocative efficiency, stability and growth. The author shows how the ratio of profit-sharing between suppliers of capital and its users can be determined rationally by the forces of supply and demand. The book surveys recent contributions to the theory of money, banking and monetary policy in an Islamic economy.

Another work related to this topic is Money and Banking in Islam, edited by Ziauddin Ahmad, Manawar Iqbal, and .M.Fahim Khan. This is a useful contribution by Muslim scholars. This book is based on the proceedings of the seminar on the Monetary and Fiscal Economics of Islam held in Islamabad, 1981. The book deals with an Islamic economy which has a bearing on monetary and fiscal policies, and its objectives and instruments. It also takes a thorough examinations of the experiments in Islamic banking in different parts of the world in general, and the Report of the Council of Islamic Idealogy of Pakistan on the elimination of interest from the economy in particular.

Another interesting work is Towards an interest-free Islamic economic system by Waqar Masood Khan. This book is basically a Ph.D thesis submitted at the University of Boston; the author has demonstrated that under a set of conditions the interest-free system is superior to the traditional system. Mr. Khan cautions the policy makers about the increased monitoring costs which Islamic financial Institutions will have to incur in order to make the new system operational.

The author arrives at the above conclusions through a rigorous analysis. In a number of ways his analysis is worth studying. He accepts the position of total prohibition of interest and adopts profit-loss sharing as the alternative for interest-based financing, but he has analysed both issues in the context of secular economy. In this way, he has departed from the usually assumed ideal Islamic society condition. Among the important works done by a non-muslim on this topic includes Ingo Karesten's paper "Islam and Financial Intermediation" in IMF's Staff papers, (March 1982). This paper describes a number of steps that have been taken towards the Islamization of financial system. It reviews some of the practical issues that have to be resolved; and analyses the implications for savings, investments, and development process. Particular attention is paid to the Pakistani Model. Some of the problems, the author points out are : how to ensure that the uncertainties implicit in this system do not undermine saving incentives. He, however, finds it difficult to make any assessment of the prospect for the financial success of Islamic banks, because information on their performance is rather limited. A critical survey of Islamic economics, entitled, 'The Economic System in Contemporary Islamic Thought: Interpretation and Assessment', by Timur Kuran is in International Journal of Middle Eastern Studies (U.S.A.) Vol. 18, 1986, pp. 135-164. This is an scholarly paper, fully documented and useful contribution in Islamic economics. In the paper author raises serious questions about the claim that Islamic economic system provides a functional alternative to existing system. While focusing on the central features of proposed system where individuals are guided in their economic decisions by a set of behaviour norms, mainly derived from the Qur'an and sunnah, the author says that the implications of these norms are ambiguous in most of the context where they are expected to operate. Moreover, these norms cannot fit into the modern society of today. In the paper the author has also examined the role of state in Islamic economic system, the institution of zakah and the rationale for the prohibition of interest, and finally the contemporary experiences of Islamic banks.

As for the prohibition of interest, the author belives that it is unenforceable in a large society. Unless one can show that people's need to borrow and lend at interest would disappear with the establishment of an Islamic system, it is reasonable to expect interest to persist, if in thinly disguised form. He has also pointed out that even with the existing Islamic banking system, no less than in medieval financial cricles, various indirect forms of interest have been legitimized.

The author has, however, tried to show that a successful economic growth and development requires a measure of institutional flexibility. He says that even in Prophet Muhammad's time institutions were modified or abandoned as circumstances warranted. The major flaw in Islamic economics, as the points out, is that it shuns confrontation with historical evidence when the Islamic community began to grow, the spirit of the ban on interest was routinely violated throughout Islamic history. The author concludes that a large society of present day can be hardly suitable for Islamic economist's ideal economy.

This thesis attempts to describe certain salient features of Islamic banking system and focuses on the experiments carried out in Saudi Arabia and Egypt. This work, in one way, is a survey of important thoughts on Islamic banking both on theoretical as well as empirical level. Our objective is to look at the effort of the Muslim scholars devoted to the development of Islamic financial system. I have also tried to find out that how Islamic banking, based on equity participation, provides the best path of development for financial crisis facing the third world and how Islamic bank will work in competition with Western banks and what are its tools and rationale behind the operation. It is this problem of feasibility, especially in respects of Egypt and Saudi Arabia, that forms the subject-matter of this thesis. In short, it is concerned with idealogical as well as practical problems of Islamic banks. Much of my discussion is based on the literatures produced by Islamic writers. I have tried to raise the various important issues that are under constant discussions. My purpose is to highlight these issues so as to see in the framework of contemporary economic theories. For example, how in the absence of interest rate, the profit-sharing will substitute the mechanism of western financial institutions.

The available literature on Islamic banking consists of either writings of a theoretical nature explaining how Islamic banking would work in an interest-free atmosphere or some articles reports. However, an attempt was made to collect as many reports and documents, on Islamic banks as possible. Proceedings of various international conferences on the subject have also been used in this thesis. A recent report on the problems of Islamic banking published by International Monetary Fund (IMF) covers gives an interesting account of the feasibility of Islamic financial system. The report of Islamic Research and Training Institute, Jeddah, also provides important data on the working of Islamic banks. It deals with business operations of Islamic banks and associated problems. The thesis is divided into seven chapters. The first chapter traces the origins of modern controversies on interest. The second chapter deals with critique of interest, and profit-sharing system. Chapter three describes the historical background of Islamic banking and focuses on its various financial instruments. It also examines the business practices of Islamic banks. Chapter four indentifies certain problems that hinders the effective implementation of Islamic banking system. Chapter five is on the monetary system of Islam particularly in the context of modern literature written by Muslim writers. Chapter sixth and seventh are devoted to the critical assessment of the experiments in Islamic Banking in Egypt and Saudi Arabia. Useful appendices have been added which contain some important data regarding the performance of these Islamic banks.

CHAPTER - I

ORIGINS OF MODERN CONTROVERSY ON INTEREST

Throughout the history, interest has been an important topic of discussion everywhere. Almost all the religious thinkers and and philosophers of the world have condemned it. With the passage of time various theories of the rate of interest were put forward. Available literature on this issue is full of arguments about the high and low rate of interest. Even in modern world, economists believe that, interest creates "liquidity preference" for speculative purposes and results in keeping a large part of the money supply in hoards waiting for the rate of interest to rise.[1] In the Islamic world too there emerged differing views regarding the words 'interest' and'riba' (usuary). Among the Islamic writers, the prevalent view is that the institution of interest is 'neither indispensible nor ineradicable'. Most of the Muslim economists think that interest should be prohibited regardless of its level

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1 Ernest Mandel, Late Capitalism, (Narfolk : The Thetford Press Limited, Thetford, U.K., 1983), Ch.14. The author, while tracing the evolution of capitalism, gets the conclusion that ongoing increase in the nominal rate of interest combined with permanent inflation may forbid longterm investment project altogether, i.e.; both reinforce the reduction in the turnover-time of fixed capital due to the acceleration of technological innovation, and postpone indefinitely certain projects which are too risky because of the long duration of tunover involved in them (p.454).

and of the nature and purpose of the loan involved. However, there are still many others for whom it is not at all clear whether the Qur'anic ban also covers that institution of interest as it exists today. They claim that what Qur'an banned was the ancient Arabian practice of riba, which allowed the doubling and redoubling of debt when the borrower failed to make restitution on time. They think that in pre-Islamic Arabia, riba was responsible for the effective enslavement of people. The purpose of the Qur'anic ban, in their view, must have been the 'elimination of this potent source of inequality and communal friction'.[2]

Whether the ban was in fact intended to apply on all the forms of interest, this was not clear even to the early Muslims.[3] However, a controversy that is often raised is in regard to the defination of riba. While explaining the controversy on riba, as a result of some conflicting Traditions, some modern writers have started thinking that the controversy on riba is not due merely to

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2 Timur Kuran, "The Economic System in Contemporary Islamic Thought", International Journal of Middle East Studies (U.S.A.), vol.18 (1986), pp. 135-164.

3 The doubts concerning this issue have been documented by Fazlur Rahman, "Riba and Interest", Islamic Studies, (Karachi), [illegible]-1966, p.44

the meaning attached to it by some translators of the Qur'an; for if that were the case then the insertion of the word 'interest' for 'usury' in the translation would have resolved the matter. The fact that there was room for different interpretations of the Qur'anic injunctions against riba is traceable to the time of the Caliph 'Umar in the first century of the Islamic period, who is quoted as having said : 'The last to be revealed was the verse of usury (riba) and the Prophet expired without explaining it to us. Therefore, give up usury or anything resembling it.[4]

In this way, it is implied that not only 'Umar wished there were a greater explanation regarding all aspects of riba, but also that he wanted an interpretation according to which one must avoid anything which might resemble riba. One writer, on the basis of Caliph 'Umar's views, writes that :

> "If he (Umar) meant that riba is usury then Islamic behaviour would require two kinds of patterns, one a following of the given interpretation case by case as established by fiqh (systematic interpretation of Qur'anic injunctions), and the other,

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4 This report is recorded in the Musnad of Ahmad b. Hanbal the Sunan of Ibn Majah, Musannaf of Ibn Ali Shaybah, Dala'il al-Nubuwwah of al-Bayhaqi and similar other compilation of the Muhaddithun of the later period. See 'Ali al-Muttaqi, Kanz al-'ummal, 1312 A.H., 11:231 (No.4954)., as cited by Fazlur Rahman., Op.cit., p.8

> in case of doubt, in which a person must follow his best judgement until assessment is given by ifta (the scholarly exercise of such judgement). If, on the other hand, 'Umar meant interest in his statement, then only nonmonetized transactions in the form of barter may involve some problems of interpretation. For monetized transactions any interest above zero would qualify as riba. In the case of nonmonetized transaction there are also two types of behaviour patterns under the latter interpretation of riba; first, avoiding examples involving barter which had been declared as constituting riba by the Prophet Muhammad, and second, monetized transactions through the market and thus avoiding problems of interpretation".[5]

In fact, the main issue of this controversy is the effort to make a distinction between riba and interest. The conflicting Hadith literature (which we will elaborate later on) do not help to define riba in exact manner. But at the same time the view may be taken that the Qur'anic injunction against riba are absolute and thus the prohibition must be accepted as they stand. Imam Razvi and other scholars of Islamic law have presented a variety of arguments for these injunctions. In the final analysis

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5 M. Siddieq Noorzoy, "Islamic Laws on Riba (Interest) and their Economic Implications", International Journal of Middle East Studies, (U.S.A.) vol. 14(1982), pp. 3-17.

they are reduced to the two types of loan transactions on consumption and investment, and the reasons attached to the prohibition of <u>riba</u> on these types of loans.[6] Among the contemporary writers, both views are found; one is that the positive rate of interest is acceptable for the modern commercial transaction, whereas economic rate of interest occupies the same place as price and regulates the supply and demand for credit, and in this way ration it among the customers. Yusuf Ali, an eminent translator of the Qur'an, translates <u>riba</u> as 'usury' and states that "My defination (of usury) would include profiteering of all kinds but exclude economic credit, the creature of modern banking and finance".[7] However, this view is rejected by several modern writers. They generally interprete <u>riba</u> to mean interest rather than usury, and thus argue for a zero rate of interest

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6 See M.A. Mannan, <u>Islamic Economic : Theory and Practice</u>, (Idarah-i Adabiyat-i Delhi, 1980), pp. 157-159 and Qureshi, <u>Islam and the Theory of Interest</u>, pp. 45-48.

7 <u>Holy Qur'an</u>, tran. (3rd ed.) Yusuf Ali, p.111, p.324.

on all transactions.[8]

Meaning of Riba

As mentioned above the Arabic word riba literally means 'increase or addition of to any thing'. It also means 'expansion and growth'.[9] The Qur'anic suras as quoted earlier clearly indicate the meaning of riba : "God destroyes riba but makes alms

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8 See for detail but uncritical study, M.N. Siddiqi, Muslim Economic Thinking : A Survey of Contemporary Literature, (Leicester: The Islamic Foundation, 1981). The author has presented the views of Islamic writers who have analysed the role of interest in the economy and have traced the consequences of its abolition. Muslim scholars compare interest and "profit share" as means of mobilising saving and channelising them into the productive process. They have pointed out that the institution of interest introduces an essential duality of interest between the capitalist and the entrepreneurs, which is a source of fluctuation in the systems. According to them, by abolishing interest and bringing the capitalists and the entrepreneurs together on the basis of profit-sharing, Islam ends this duality and harmonises the interest of two classes. However, their main argument against the interest is that the borrowed capital whose repayment to the lender is guaranteed takes no part in the enterprise in which it is invested and is, therefore, not entitled to any returns even when the enterprise does make a profit. This capital does not expose itself to the risks and uncertainties of the enterprise (p.64).

9 See the word riba in Ibn Manzur Lis'an al-Arab (Beirut : Dar Sadir Li Taba'a wa'l-Nashr, 1968), vol.14, pp. 304-7, as cited by M. Umar Chapra, 'The Nature of Riba in Islam', Hamdard Islamicus, vol. 7; 1984, p.4.

prosper" (11:276) and "And whatever you invest in riba so that it may increase upon the people's wealth, it increases not with God". (xxx:39).

Thus, it is not every increase or growth which has been prohibited. In Islamic jurisprudence it is defined as "an increment in money or goods having no compensation in a transaction". In other words, it is a predetermined excess or surplus over and above the loan capital received by the creditor conditionally in relation to a specified period.[10] Thus it includes all types of interest resulting due to late payment or due to unequal exchange of the same commodity.

The question whether the ban on interest should also apply to commercial bank interest charges had for long been debated.[10] Those who support the commercial interest think that Islam prohibited interest only on consumption loan, which entitled exploitation of the needy and the underprivileged. So far as commercial and productive loans are concerned, Islam has no objection to them. As such there is nothing wrong with modern banking.

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10 Abu'l-A'la Mawdudi, "The Prohibition of Commercial Interest in Islam", Islamic Thought, (Aligarh), vol.7 (July-September 1960), p.36.

Although the controversy has continued for long time, especially in the christian world after the industrial revolution, it did not carry much weight with the Islamic people. The early Muslim modernists opposed riba but defended interest. Now the idea is gaining ground among many muslim writers and economists that interest is prohibited in all its form.[11] The Islamic injunction against riba is in fact a special case of a more general rule which prohibits all financial deals which promote social inequalities. A contemporary muslim economist has asserted that :

> "Prohibition of riba is the Islamic rejection of a particular mode of capital pricing, namely through positive interest rates, which offends the Islamic ethical philosophy instruments. It follows that to enforce the Islamic injunction, alternative means must be found to price capital

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11 Mohsin S. Khan and Abbas Nirkhor, "The framework and practice of Islamic banking", Finance & Development/ September 1986), p.33., also in detail, see Khursheed Ahmad (in forward), A Survey of Issues and a Programme for Research in Monetary and Fiscal Economics of Islam, (Islamabad : Institute of Policy Studies, 1981), p.2. It is now a general view that Islam is opposed to the principal of a fixed predetermined return on capital, whether used for consumption or productive purposes and whatever be the rate of this predetermined return, normal or exorbitant.

appropriately, satisfying the requirements of Islamic ethics". 12

The concept of the cost of capital is a controversial issue among many Muslim scholars. In modern context, the cost of capital originates from the concept that money is a limited stock and it cannot be a free commodity, hence there should be a price for it.

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12 S.N.H. Naqvi, Ethics and Economics, (Leicester: Islamic Foundation, 1981), p.43; Muslim Scholars, generally do not accept the cost of capital, because, if a saver deposits his money in a bank, he can always draw his money from the bank and avail of the 'opportunity' that he may have come across. Therefore, there is no opportunity cost involved - In fact the concept of opportunity cost of capital was raised by the money — lender to legitimise to their unlawful interest earnings. Originally there was a lot of resistance on the part of Church to allow usury. Then the opportunity cost argument was coined to persuade it to allow interest in those cases where a lender losses an opportunity to invest, if it arises during the period his money is being used by the borrower. The church agreed to relax the prohibition of usury on the basis of this argument. From this relaxation followed the wholesale legitimisation.

Modernist Views on Interest

It is generally asked whether there is any distinction between riba of the Qur'an and the interest of the capitalist world.[13] This is an important question because it makes one to further ask whether an interest-free economy can come into existence and further that what is the alternative of interest and whether the elimination of interest from the economy can be replaced by profit-sharing system. The modernists "think that the prohibition on borrowing and lending at interest can only be enforced in a primitive Islamic society with Islamic morals.[14] This important assumption is considered necessary before interest-based system is eliminated. The main reason for the modernist

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13 M.A. Mannan, Islamic Economic : Theory and Practice, (Idarah-i-Adabiyat-i-Delli, 1980), p.158; A searching criticism of some recent attempt to justify interest has been made by Mahmud Abu Saud, who also warns against the tendency of treating money capital as if it were capital goods or real assets, a tendency that has become quite frequent in modern literature. Western writer, particularly, equates the price with the rental use of money, giving the impression that to use the service of money is exactly as to use the service of a doctor. The obvious objections to treating interest as rent are that money as a medium of exchange is not supposed to depreciate and that you do not rent something that perishes or disappears once you use it. See for detail, Abu Saud, Mahmud, "Interest free banking". Paper presented at the First International Conference on Islamic Economics, Mecca, 1976, Mimeo., p.164.

14 For an excellent discussion see; S.N.H. Naqvi, Ethics and Economics : An Islamic Synthesis, (Leciester : Islamic Foundation, London, 1982).

to defend interest is that, the economies of the Islamic World have shifted to a greater extent into the western block and no doubt, for this, 'many obstacles of religious nature come in their way to reach the western standard of living and to adopt the monetary instruments and the institution of the West. But so far as monetary conditions are concerned, the main facts to be noted is that the Qur'an prohibited riba which according to traditional interpretation should also cover interest'.[15]

The modernists believe that what Islam prohibits is riba and not interest. In their opinion interest paid on loans for investment in productive activities would not contravene the laws of the Qur'an, for it refers only to riba on non-productive loans which prevailed in pre-Islamic times when people were not familiar with productive loan. The basis of the injunction against riba on consumption loan is that those who borrows are assumed to be in need of such loan for purpose of maintaining some standard of living. To make loan to another without riba, then, is an act of charity. Thus, those with higher incomes,

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15 Ulgener Sabri, Monetary Condition of Economic Growth and the Islamic Concept of Interest, Islamic Review (London), No. 55, No.2, February 1967, pp. 11-14.

therefore, higher savings, are asked to make loans to those with lower income who are in need without having to extract riba from them. The prohibition of riba on consumption loan is also clearly aimed at the allocation of purchasing power from the rich to the poor. The loans can be classified into consumption loan and production loan and that riba forbidden by the Qur'an is that which is connected with consumption loan only. It is thought that in the case of production loan, where, due to investment in productive projects of lucrative return, there would be no sin in demanding interest.[16]

Production Loan

Regarding the controversy over the productive and non-productive loans in pre-Islamic Arabia there are still differences of opinion on this : the modernists argue that people of the pre-Islamic Arabs resorted to riba for meeting their consumption requirements only. Therefore, in their view, the Qur'anic prohibition of riba, in any case, cannot apply to such economic

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16 Sayyid Ahmad Khan, Tafsir al-Qur'an, vol.1, pp. 298-313, Aligarh 1882., The Indian Modernist, Sayyid Ahmad holds the view that interest on production loan is not riba and that interest on consumption loan would be riba only if the debtor was poor and not able to pay the interest.

practices which were not present at that time.[17]

Among the Muslim modernists Muhammad 'Abduh is considered as the first among the prominent 'ulama' of modern times who initiated a discussion on the problem. He is quoted as having recommended bank interest as lawful according to the shari'ah. It is said that he gave this opinion at the request of the Postal Authority of Cairo. 'He gave a verdict that the profits on the postal saving accounts operated by the Muslim depositors could be apportioned by them. It should not come under the category of riba, but it should be treated as profit gained from

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17 CF. Ziauddin Ahmad, 'The Theory of Riba, Islamic Studies, Vol. 17, 1978. The author has mentioned the Egyptian Ulemas, who were in favour of bank interest merely on the above ground. All of them suppose that bank interest is not 'riba'l-nasi'ah, hence lawful. They also regarded it as subject to ijtihad as riba'l-fadl. The author has presented the view of 'modern Arab 'Ulema, some of whom held the post of Shaykh al-Azhar i.e., Mufti Abdhuh, Rashid Rida, Mahmud Shaltut, Abd al-Wahab al-Khallaf, Ibrahim Zaky al-Din al-Badwai are reputed for their opinion that present bank interest is not the same as riba in Qur'an.

Mudarabah business undertaken by the postal authorities'[18] Muhammad Rashid Rida, the disciple of Muhammad 'Abduh followed his master in this respect.

A modern Muslim writer says that : Rashid Rida was

> "an exponent of the *Mudarabah* theory of bank business (with interest) who very often quotes his teacher in support of the position taken by himself in legalizing bank interest from the Shari'ah view point. But according to author scholars opposing bank interest as lawful are generally reluctant to give any credential of authenticity to 'Abduh's opinion on the problem as found in the writing of Rashid Rida. In their view Rashid Rida might have sometimes attributed his own opinion to his teacher. But about another Egyptian writer the author mention that "Muhammad Shaltut, a former Shaykh of al-Azhar, refused to recognize bank interest as lawful, but later on he changed his opinion and ranked himself with Rashid Rida and others to accord sanction of legality to the present bank interest. On the other hand, Ibrahim Zaky, al-Din'l Badawi remained a stounch supporter of bank interest in his early writings, and later he reviewed his opinion and authoured the book entitled. *Nazariyyah'l-Riba'l-Muharram fil'l-Shari'a'l-Islamiyyah.*[19]

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18 *Ibid.*, p.184.

19 *Ibid.*, p.185.

Nature of Consumption and Production Loan

As far as the modernists views on the nature of loan are concerned, there is absolutely no evidence to support the contention that riba of the Jahiliyyah was on consumption and not on production loan. There are a good deal of historical record to prove that position of the Arabs in Mecca was as a trader, and hence it is difficult to believe that loans were for consumption purposes only. The Qur'anic verses about remitting the principal in the event of the borrowers hardship does not refer to consumption loan. It refers essentially to interest based.[20]

Traditional View of Interest

Traditional view on interest greatly differs from modern thinking, where Qur'anic riba and contemporary commercial interests are treated alike. In recent years literature supporting

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20 Most of the interest-based transactions mentioned in the classical commentatires in relation to the prohibition of riba are loan taken by the tribes from each other, each tribes acting like a large partnership company. (For an excellent factual presentation on the subject with numerous solid references from primary sources, see, Mufti Muhammad Shafi, Mas'al a'-e-Sud (Urdu) (Karachi, Idarah al-Ma'rif) 1374 A.H.), pp. 18-23, and 'Riba' in Urdu Encyclopaedia of Islam, (Lahore : Da'iratal Ma'arif-i-Islamiyya) n.d.

this traditional thinking are appearing at an increasing scale. Though it cannot be claimed that an interest-free system will replace present interest-based system, but the emergence of Islamic banking system (interest-free banking) have generated the debate on this issue.[21]

By traditional view here is meant that line of thinking which is in accordance with Sha'ri'ah law. The basic attitude of the traditionalist is this that riba and interest are one and the same. According to a well-known medieval Muslim theologian Fakhr al-Din al-Razi the Arabs of the Jahiliyah period recovered riba monthly without affecting the sum advanced. When the time for settlement came, the principal amount lent was demanded and if the debtor was unable to pay, the lender increased the amount in his own favour and granted extension of time. This was how the Arabs of the Jahilliyah used to transact their lending operations. From the observation of this learned jurist, it can safely be said that riba which was prevalent in pre-Islamic era consisted in extending the time limit and increasing the amount

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21 For a general survey of this point of view on interest' see Muhammad Nejatullah Siddiqi, Muslim Economic Thinking: A Survey of Contemporary Literature (Leicester: The Islamic Foundation, U.K., 1981), p.63-68 and Ariff, ed., Monetary and Fiscal Economics of Islam, (Jeddah : International Centre for Research in Islamic Economics, King Abdul Aziz University, 1982).

due so much so that the borrower would at the end of the period of the loan returned to the lender double or even more of the principal sum'.[22]

A survey of Islamic history shows that the Muslims always considered riba as forbidden. They managed their economy and carried on domestic and international trade without the institution of interest. Profit-sharing and various kinds of participation arrangement served as adequate bases for saving and investment and considerable capital was mobilized in mining, ship-building, textile and other industries as well as for war-time trade.[23] There did not exist any distinction between interest and riba but the conflict between the Shari'ah and practice continued to exist as an unresolved problem of Islamic history. It was realised that the Islamic notion of interest was mainly a medieval idea and it has no connection with what actually takes place in the modern world. As a result of this, Muslim economists started to find out the alternative of interest. It is

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22 M.A. Mannan., op. cit., p. 159.

23 Muhammad Nejatullah Siddiqi, Issues in Islamic Banking (selected papers) (Leicester : The Islamic Foundation : U.K.), p.9.

profit and loss-sharing that bears the true spirit of Islamic concept of justice.[24] Up till now a good number of literature has come out in the support of the theory that profit-loss sharing system is superior to interest-based debt financing on ground of efficiency.

Controversy on Hadith Literature

The main controversy on the riba arises due to its definition. The riba mentioned in Qur'an implies to that kind of riba which is consisted in doubling and redoubling of the original amount. This is the riba related to pre-Islamic days i.e. riba'l-Jahiliyah. Although the Qur'an does not give any specific definition of riba'l-Jahilliyyah, but its nature and characteristic

24 A Current Study on the issue is by Waqar Masood Khan, Towards an Interest-Free Islamic Economic System, (Leicester: The Islamic Foundation, U.K., 1985). The author accepts the position of total prohibition of interest and adopts profit-loss-sharing as the alternative to interest-based financing. He has analysed the issue in the context of secular economy. In this way he has departed from the usually assumed ideal-Islamic society condition. He has integrated the profit-loss sharing into the mainstream economies. This is an approach which Muslim economists could adopt to Islamise economies, instead of the more common style of stating Islamic Jurisprudence in the terminology of secular economies.

features are manifested in various riba verses of the Qur'an. The modernists also think that Qur'an prohibited only such kinds of pre-Islamic riba as used to make the principal sum several fold with the passage of time. As we have mentioned earlier, in pre-Islamic Arabia riba became due when a man owned another a debt, at the time of its maturity the creditor would ask the debtor, will you repay : Will you increase ? If the debtor paid up, the amount was received otherwise the debtor increased the amount and the creditor extended a further term.[25]

By the above statement, it is implied that credit was offered free of riba for the first term, and that the riba was charged only when the debtor failed to discharge the debt at the end of the first term. Therefore, the riba'l-Jahilliyah is certainly different from the usual interest bearing dealing which stipulates the increase from the very beginning. In comparison to riba'l-jahiliyah, and the loan with interest, in which the increase is stipulated in the first term is something different. Hence the question arises : was it not a common knowledge among the Arabs that what Qur'an prohibits is merely riba'l-jahiliyyah

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25 For an authentic point of view see, Malik, Muwatt'a, cited by Fazlur-Rahman., op. cit., p.5.

and not the riba as production loan ? This is the main point from which the controversy oririnates. The Qur'an has not mentioned clearly the nature and definition of riba. The fact that there was room for different interpretation of the Qur'anic injunction against riba is traceable to the time of Caliph Umar, in the first half century of Islamic period who is reported to have said "The last to be revealed was the verse of usury and the Prophet expired without explaining it to us. Therefore, give up usury or any thing resembling it".[26]

Thus not only Caliph 'Umar wished there were a greater explanation regarding all aspects of riba, but also that to be safe he opted for an interpretation according to which one must avoid anything which might resemble riba in dealing with others. The Hadith literature covering the various dimensions of the nature of riba is sometimes in conflict with each other. Particularly the traditions related to the exchange of same item. Take for example, the following hadith: "Abu Rafi, a client of the Prophet said : "the Prophet borrowed a young camel from some person, and when camel from the camel of the Sadaqah came to

26 For detail see, M. Siddiq Noarzay, "Islamic Laws on Riba (interest) and their economic implication", International Journal of Middle Eastern Studies,(U.S.A.), vol 18, 1986,p.4

him, he ordered me to pay back the man his young camel. When I told him that I could find only an "excellent" camel in its seventh year, he said, 'give it to him, for the best person is he who discharges his debt with something better".[27] It is said that the above tradition created doubt that the conversion of <u>riba</u> into the "virtue of the goodness' in the repayment of loan" related only to the purchase and sale of cattle. Regarding this tradition two opinions have been expressed. The first is that, if at the time of repayment of a loan, the excess paid over and above the principal sum of money is not <u>riba</u> in the case of cattle, what is to happen to the universility of the diction so very much insisted upon by our 'doctors' that every loan from which a profit accures is <u>riba</u>. 'The second question that is asked regarding this tradition is that 'goodness in the repayment of loan' in the case of cattle, becomes, when applied to forms of wealth other than cattle, an evil of enormity that it is characterised as an act of war against God and his Prophet. In this way the variation in the Hadith literature creates doubts and controversy. The Sunan of Abu Da'ud and the Masnad of Ahmad b. Hanbal are quoted to showing that such an unjust distinction between cattle and other forms of wealth cannot be attributed to the Prophet. A similar

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27 Muslim, <u>Sahih</u>, Kitab al-Bu'yu.

Hadith in the Sunan of Abu Da'ud is : "Muharib reported that he heard Jabir b. 'Abd. Allah saying that Prophet owed him [Jabir] some money and at the time of repayment of the loan the Prophet added some money in excess of the principal borrowed".[28]

The modernists on the ground of this tradition say that 'no attempt to define riba in the light of Hadith have so far been successful. The question is asked whether all the traditions relating to riba, having been found unauthentic should be rejected in toto ? It is also asked whether the Qur'anic declaration that if people do not give up riba, they should be prepared for a 'war from God and his Prophet' refers to such transaction ? and whether it is with reference to these dealings that such hadith have been narrated in which it is said that the taking of riba is as revolting as incest'.[29]

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28 Abu Dawud, Sunan, K. al-Buyu'B, husn al-gada'; Ahmad b. Hanbal, Musnad, 111:319, as quoted by Fazlur-Rahman, Op.cit., p.29.

29 Ibid., p.30., Regarding this issue, the author thinks that the evolutionary process through which these hadiths have passed, and these do not seem to be authentic. But it would be a grave folly to ignore their moral import since they are sincere and performed attempts at interpreting and elaborating the sunnah of the Prophet and the Qur'anic injunctions. The Fact is that the spirit underlying these efforts was the Qur'anic spirit in respect of economic life and economic system that it wanted to promote. Therefore, in order to understand riba as meant by the Hadith, it is first necessary to understand what the Qur'an meant by riba (p.30).

Regarding the various types of Hadith on riba, a modernist writer says :

> "The contradiction found in the Hadiths in respect of riba is difficult to resolve. On the basis of isnad alone, there is not much scope either for the rejection or accpetance of these traditions because, the Sihah works contain a good number of Hadiths on each aspect of these topics. Every one of these Hadith is either Sahih i.e. supported by a strong chain of authorities or is supported by other Hadiths of the level of Sahih Hadith. The surmise made on the basis of qiyas (analogy) are not so important in our opinion as the historical order of these Hadiths, because the historical order is something which is based on certainty, and is not a mere matter of probability. If these Hadiths are viewed in this way, it becomes apparent that there is a clear process of development involved therein .... This process of development is at the bottom of the contradiction found in Hadith material. Besides, the abovementioned contradiction most of these Hadith are full of other complexities, which we find it almost impossible to resolve".[30]

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30 The author mentions that if there is hand to hand exchange of articles like gold, silver, wheat, dates or salt in excess or in deficiency, that would become riba, in accordance with the most widely current traditions. This is called as riba'l-fadl. The author put question that whether the Qur'anic declaration that if people do not give up riba, they should be prepared for 'a war from God and His Prophet'. refers to such transactions and whether it is with reference to those dealings that such hadith have been narrated in which it is said that the taking of riba is as revolting as incest. The author quotes the Muwatta of Malik and the Sahih of al-Bukhari, who say that excess is permissible in a transaction involving cattle, even on credit, and such excess cannot be characterised as riba. The question, therefore, arises as why such excess in respect of other forms of wealth should be considered riba. Further more, the Sahih of Muslim and other Sahih-works contain hadiths showing that the credit transactions, not only of cattle but even of slaves and coins of copper is permissible, even when such transaction involves excess. See al-Bayhaqi, 'al-Sunan al-Kubra', (Hyderabad), 1352. A.H., V: 288; as quoted by Fazlur Rahman, Op.cit., p.20.

The above statement throws some light on the complexities of Hadith that concern with riba'l-fadl. In view of these sharp differences found in the Hadith literature the modernists do not think the commercial interest also comes in the category of riba.

So far as riba'l-nasi'ah is concerned, there is hardly any difference of opinion among Muslim writers because Qur'an has clearly mentioned it. The controversy arises from the riba'l-fadl which concerns the exchange of the items about which there are contradictory statements in the Hadith.[31]

In modern times, particularly when the commercial interest is considered as Qur'anic riba by the Muslim traditionalists, their most persuasive argument against interest is that it is

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31 For detail see Fazlur Rahman n, "A study of commercial interest in Islam", Islamic Thought (Aligarh) 5 (4 & 5) July-October, 1956, p. 24-46; In fact, the prohibition of riba'l-fadl has been looked upon as a discouragement of barter and a step directed at monetization of the economy. The primary aim of this injunction is, however, to eliminate the possibilities of exploitation and injustice similar to that which is the target of prohibition of interest on money loan. See Sheikh Ahmad Irshad "Islamic Economy and the Elimination of Interest", Voice of Islam (Karachi), vol. 12; November 1963; pp. 78-85.

unjust to demand a reward without participating in the risk of enterprise. But according to this definition large number of economic transactions can be brought under riba. 'What about a doctor who charges a fixed fee without ensuring that his treatment would certainly have a positive effect on the patient ? Again, why should a lawyer charge a fixed wage rate without being able to guarantee the successful defense of the client? and why should a labour union contract for a fixed wage rate without caring for the profitability of the enterprise? These are the important question when the nature and definition of riba is discussed.[32]

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32 This is a complex point in Islamic economic literature. For a full discussion see Waqar Masood Khan's admirable, Towards An Interest-Free Islamic Economic System, (Leicester : The Islamic Foundation, U.K., 1985). The author notes that it is not a fixed predeterment reward that makes a payment riba nor is it non-sharing of risk. Riba is an increment on Principal sum, which does not have an equivalent in exchange. The lender gives the money to the borrower and takes it back, but the interest that the former receives is not compensation for anything.

CHAPTER - II

MUSLIM CRITICISM OF INTEREST AND PROFIT-SHARING

During the recent years there has emerged a growing interest in the monetary and fiscal economics of Islam. Based on the contemporary debate in western economies on these issues some Muslim apologists are trying to work out the monetary and fiscal policies of their countries which they call 'Islamic Economics'. The two most important pillars of 'Islamic Economics'- the institution of Zakah and the prohibition of riba - are fiscal and monetary measures around which most of the contemporary literatures on 'Islamic economics' revolves.[1] It is claimed that if riba is prohibited, banking and other financial institutions could function efficiently on the basis of profit-sharing. But some Muslim apologists have begun to ask question whether they should carry on their analysis within the framework of the capitalist system or they should depart from the capitalist system and be attached with the ethical value system of Islam. In this connection, the following remarks of a Muslim apologist are

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1 M.A. Khan in., Muslim World Book Review, (London : Islamic Foundation 1981), vol.2, 1-4, p.47.

interesting. He says that 'One-dimensional thrust of Western economic thought, which is based on the vision of eighteenth century England, have kept Muslim economists on the straight and narrow path. According to him 'Muslim economists are deeply sunk in the quicksand of western economic paradigm. From the statements of objectives onwards, they have adopted the western economic paradigm in its totality. The major themes of western economics occur again and again in the literature on Islamic economics : 'productivity', 'macro-consumption economics', 'full-employment'; 'economic growth', 'welfare programmes', 'cost-benefit analysis' and 'monetarism'. Because the main frame of reference is the western economic paradigm, its tools, methodologies, issues and institutions are accepted and questions are always asked in relation to them... These metaphysical notions, and the accompanying borrowing of institutions, ideas and tools of the western economic system, are implicitly leading Muslim economists to produce policies that are hardly different from the capitalist and socialist alternatives. In the end they will lead the muslim countries to the same crisis that confronts industrialized societies".[2]

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2 Ziauddin Sardar, "Islamic Economics: From partial to Axiomatic Approach", in Islamic Future (Mansell publishing Limited, 1985, U.S.A.), p.207.

Questions are being asked as what is Islamic economics ? How does it differ from the conventional capitalist and socialist models ? What are its axioms and principles ? How will Islamic economics replace the dominant economic orders in Muslim societies ? It is generally felt that the elimination of interest is not the only condition for the Islamisation of the economy, as it is evident from the fact that a socialistic economy, which is contrary to Islam, also functions on the basis of a zero rate of interest in financial transactions. Thus the abolition of interest is not a necessary first step to attain a truely Islamic state. It is argued that 'a transitional Islamic society will have to shoulder this "necessary evil" till a truely Islamic state is finally established, in which case, of course, there would not by any need for the rate of interest to exist any longer".[3] According to a modern Muslim writer "Islamic economics is not capitalism minus interest plus Zakah or socialism minus state control plus Allah".[4] Another Muslim writer explains the rationale behind the prohibition of interest in these words :

> "If the Islamic system is equated simply with the abolition of interest and introduction of Zakat, this would amount to some kind

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3 S.N.H. Naqvi, Ethics and Economics, Ch.7; p.109.

4 This remark is made by Ziauddin Sardar, Op.cit., p.199.

> of an over simplification. I agree that abolition of interest and the introduction of Zakah are the most important pillars on which we have to base new structure of society and economy, but they do not go to make up the whole structure ... Abolition of interest is one of our primary targets. Establishment of Zakah is a priority of objective in our scheme. But they do not constitute the be-all and end-all of the Islamic economics .... our target is a fundamental change in the economy and society : a change that affects people's attitudes and motives, their consumption and production relationships, society's institutions and structures, individual life styles and collective policies at all levels.[5]

The rationale of the prohibition of interest is looked rather with doubt. A numbers of points are raised. Regarding the traditional view that business partners face the risk of a possible loss whereas the lenders face no risk at all as the reason for prohibiting interest, Homa Katouzion, says there is nothing in the Qur'an and tradition to say that riba is prohibited because it does not involve the lender in the risk taking. He further says that the rate of return on capital bears a relationship to the degree of risk involved in various types of investment

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5 Khurshid Ahmad made this remark on opening speech in Ariff (ed.) Monetary and Fiscal Economics of Islam (Jeddah: Internal Centre for Research in Islamic Economics, King Abdul Aziz University, 1982).

The higher the risk, the higher the rate of return. A borrower would normally expect a lower rate of interest than rate of profi he would have earned on his capital had he entered a partnership with borrower. In this way, they each take different degree of risk and expect different rate of return. He also thinks that there are various degrees of risk and rates of return associated with different types of business activity. In some partnership, the partner may face higher risk, and even higher profits, than others. But Muslim economist does not maintain that business involving higher risks are superior to those facing lower risk. As it can be seen however, there is no genuinely risk-free decision of any kind, and, in any case, the degree of risk is related to the rate of return.[6]

The emphasis of the Muslim idealogue is that the Islamic economic system is a part of the total Islamic way of life. For a balanced economic growth 'curbing conspicious consumption, both private and public, and guaranteeing a minimum level of consumptio to all, accompanied by fiscal discipline ensuring the channelisation of the additional incomes generated to capital formation', are essential'.

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6 Homa Katouzian, Review on Siddiqi's Book in International Journal of Middle East Studies, Vol. 17., 1985), p.295-311.

'Islamic economics' as it has been already mentioned have still not faced a testing ground. That is why Islamic economic theories cannot be justified merely on the ground, as they claim, that other prevailing systems have proved a failure. Not only the concept of interest, but important aspects like the Zakah and Islamic financial systems still remain obscure. They discuss Islamic fiscal policy within the framework of Islamic distributive justice. Zakah dominates the whole discussion, as if distributive justice is concerned only with transfer payments and as if Zakah is the only instrument available. Islamic thinkers have expressed differences of opinion with respect to Zakah base. One view is that Zakah is a form of wealth tax and therefore, it is not permissible to include income in the Zakah base. Another view is that Zakah must be paid on a Zakah-able asset regardless of whether it is owned by private individual or by government, it is because Zakah is earmarked by certain purposes as spelled out in the Qur'an, whereas Government revenues are not. One writer rejects this point and says that commercial exploitation of mineral resources can be undertaken only by the state and not by individuals. He even goes so far as to suggest that revenues from such state-owned mines are similar to Zakah, regardless of whether these are used to benefit the poor or society as a whole.[7] The question is generally raised: what will

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7 Mohammad Ariff (ed.) Monetary and Fiscal Economics of Islam., p.16

happen if interest is abolished in an Islamic economy? It is claimed that the profit-loss sharing system is superior to interest-based debt-financing on grounds of efficiency. The prevalence of debt-financing in the world is explained by the high information cost of profit-sharing system.[8] Islam, as it is believed, is neither opposed to competitive effort nor is averse to the operation of market forces. But monopoly, hoarding, speculation and other unIslamic practices have been banned.[9] Islam like capitalism, permits private ownership of property including the means of production and grants freedom of enterprise. It holds trade and therefore production in high esteem.[10]

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8 Waqar Masood Khan, Towards an Interest-free Islamic Economic System, (Leicester : The Islamic Foundation, U.K., 1985), p. 126., It is originally a Ph.D thesis at the University of Boston.

9 The Qur'an condemn the hoarding of wealth in following words : "And let not those who hoard up that which Allah hath bestowed upon them of His bounty think that it is better for them. Nay, it is worse for them. That which they hoard will be their collar on the Day of Resurrection. Allah's is the heritage of the heavens and the earth, and Allah is informed of what ye do (111:180).

Even Prophet is reported to have said : "Fear God and be moderate in your pursuit of wealth, take only that which is allowed and leave that which is forbidden". Ibn. Majah, vol.2, p. 725:2144.

10 Zubair Hasan, "Theory of Profit :The Islamic Viewpoint". Journal of Research in Islamic Economics, (Jeddah) King Abdul Aziz University, vol. 1-1-summer 1983, p.14.

Interest and Islamic Economy

Keeping in view the function of interest in the capitalistic system, it is argued that interest cannot be abolished instantly from the "Islamic economy", for if it is done so there are chances that economy will collapse. Because a capital scarce economy in transition to an Islamic economy will need a rate of interest which performs certain desirable functions, and in the absence of interest it cannot acheive its goals. Thus interest rate would be required to allocate scarce resources optimally among various sectors of the economy. Moreover, in a dynamic economy's positive rate of interest is desired to account for the positive social rate of time preference, for the social cost of capital consumption resulting from its use, and for the declining real value of saving over time'.[11] Hence for an economy in transition to the Islamic state, a positive rate of interest cannot be substituted by the

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11 Even in the socialistic system the price of capital is counted. Recent studies shows that planners in the Soviet Union are anxious not to be denounced as apologists for capitalism; yet they need some form of interest rate (or "discount rate", or "payoff period") for making efficient investment calculations. See, Paul A. Samuelson., Op.cit., p.669.

Islamic concept of profit-sharing.[12] For an economy in transition to the Islamic state, a positive rate of time preference can move towards zero only by extensive cut back on consumption, which means that public saving will take the upper hand and less reliance would be placed on private saving. While abolishing interest in the transition period, government interference will be necessary in creating saving, cut back in consumption loan, increase in real investment and so on. In short, the presence of the interest rate is a "necessary evil" in a capital scarce economy during its transitional phase to full-fledged Islamic economy. If the rate of interest is at all to be abolished, then it will lead to gross inefficiencies.[13]

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12 An important function of the rate of interest is that it is essential for the efficient allocation of scarce investment resources. Interest is a device that service two functions in the economy. It provides an incentive for people to save and accumulate wealth. But the interest rate is also a rationing device; it allows society to select only those investment projects with the highest rates of return. Interest rate play a major role in determining the market value of asset. 'When the interest rate drops from a high to low level, there follows a rise in the present value of existing machines, land, bons, stocks, yielding a stream of future return. The rate of interest also performs the functions of safeguarding the real value of private saving. Besides this interest income provides the reserve funds to finance monetary escalation of money expenditure on depreciation and new investment.

13 S.N.H. Naqvi, 'Interest Rate and Intertemporal Allocative Efficiency in an Islamic Economy, in Ariff (ed.) <u>Op. cit</u>., p.43

Partnership and Profit-sharing

Replacement of interest by profit-sharing is the basic "reform", that has been advocated by Muslim economists. The reason behind it is that the 'investor faces an uncertain world in which the result of his enterprise cannot be forseen with certainty.[14]

What is this 'partnership and profit-sharing' ? and how much it is different from the concept of interest ? and can this be substituted in place of the functioning of interest without doing any harm to the economy ? Muslim scholars are at pains to prove the efficiency of profit-sharing system, but not without much complexities that are associated with this.

There is a general consensus among the Muslims that profit-sharing is legitimate in Islam, and an alternative to interest. What makes profit sharing permissible in Islam, while interest is not, is the fact that it is the profit-sharing ratio and not the rate of return which is predetermined. It is because, the

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14 Almost every Muslim scholar has emphasised this point. For a comprehensive account on this use. See M.N. Siddiqi, Muslim Economic Thinking., Ch., 4.

owners of capital have no priority over others in the form of a fixed rate of return.

As for the complexities are concerned, it is said that the substitution of interest with profit-sharing would lead to monopolies, allocative inefficiency and economic instability and so on. It is also felt that inflation might exist in the profit-sharing system. The reason is given that some possible factors may contribute the inflation like excess demand, shortage of supply, market regidities and unbalanced resource allocation between luxuries and necessities, specially those which can artificially be created.[15]

Definition

'Shirkah means participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profits and loss in specified proportions.

'Mudarabah means that one party provides capital and the other utilises it for business under the agreement that

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15 Ariff (ed.) Monetary and Fiscal Economics of Islam., p.260.

profit from the business will be shared according to a specified proportion'.[16] Thus, the most accepted solution for interest is the application of the principles of shirkah (partnership) and mudarabah (profit-sharing) as the medieval Muslim jurists have accepted that as legal. Now the main concern is that how the profit-sharing works in an interest-less Islamic economy. The main economic arguments are given as follows :

The Islamic jurists have worked out the details about shirkah and mudarabah on the basis of the Qur'an and sunnah. A deeper analysis of the concept of mudarabah reveals that it is essentially an investment-management agreement. The sahib al-mal (capital contributor or investor) is basically not the lender but the owner of the business to the extent of his shares

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16 Muhammad Nejatullah Siddiqi, Partnership and Profit Sharing in Islamic Law, (Leicester : The Islamic Foundation, 1985), p.15.

Also, under Mudarabah, the party that provides the merchandise and the party that engages in business may each comprise many persons, i.e. the capital may be provided by several persons and the business may be carried out by several other persons. Alternatively, capital may belong to one person and the party that utilises it in business may be many or several persons may pool their capital while one person uses if for carrying on business.

in the total financing of the business. The mudarib, (manager or enterpreneur) manages the investment fund placed at his disposal by the sahib al-mal in accordance with the mudarabah agreement. Mudarabah is a form of equity which is temporary in nature and is liquidated as soon as the objectives are realized. In accordance with the rationale behind the prohibition of riba, the manager of Mudarabah funds is not entitled to a fixed return for his management services irrespective of what happends to the business. If there is a profit, he shares the profit in an agreed proportion as a reward for his managerial and entreprenurial services. If there is a loss, he gets no reward, and his loss amounts to the opportunity cost of his services. However, he shares the loss if he has a share in the equity of the business, but only to the extent of his shares because losses according to the fuqha constitute erosion of equity. This fits perfectly into the rationale of the Islamic model of Riba-free economy and implies that the spirit of business relationship preferred by the Shari'ah is "investment management" and not "borrowing-lending", taking into account the modern connotation of these terms.

Equity financing in place of loan-financing will help eliminate the possibility of a large superstructure of finance being raised on a narrow equity base. It would help bring about a wide dispersal of ownership of business and contribute substantially to the realization of the goal of equitable distribution of income and wealth.[17] It is said that expected rate of profit in the economy will play the allocative role which is supposedly played by the rate of interest in the modern economies. Accordingly capital as a scarce factor of production, will have a price, not in the form of a pre-determined rate of interest, but in the form of a probable rate of return thrown up by the profit-sharing system. Savers will have the expected rate of returns to bank deposits on the incentives to save and deposit their saving in bank investment accounts. The profit-sharing arrangement would result in a just and equitable sharing of social surplus. The system based on interest is unjust because it guarantees a definite positive return to the financier whereas the value productivity of investment is uncertain.[18] Thus, it is claimed that profit-sharing system is not only feasible, it is also more efficient than the system based on interest.

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17 M. Umar Chapra, "Money and Banking in an Islamic Economy", in Ariff., Op. cit., p.153

18 M.N. Siddiqi, Issues in Islamic Banking., p.125.

This profit-sharing, which include also the risk sharing is considered the only alternative for interest. Muslim apologists believe that principle of profit-sharing will ensure mobilisation of saving, its channelling to productive enterprise, and its allocation in accordance with social preference will be achieved by the rate of profit. This rate of profit, according to them, will be more efficient mechanism for allocation of resources than interest. 'The rate of interest tends to be a "perverted" price and reflects price determination in favour of the rich, the more "creditworthy" the borrower, the lower the rate of interest and vice versa. The result is that "big" business is able to get more funds at a lower price because of its "higher" credit rating. Thus those who are most able to bear the burden, because of their bigness claimed "higher" productivity, bear the least burden.[19] In this system if there is a profit, the entrepreneur shares the profit in an agreed proportion as a reward for his managerial services. If there is a loss he gets no reward. However, he shares the loss if he has a share in the equity of the business. It is further argued that,'a wholly equity-based system,

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19 M. Umar Chapra, "Money and Banking in An Islamic Economy" in Ariff., Op.cit., p.160.

with the rate of profit not fluctuating as erratically as the rate of interest and the distribution of the total return (profit + Interest) between the entrepreneur and the financier determined more equitably, should on the contrary tend to have the effect of reducing rather than accentuating economic instability'.[20] As regards the differences between profit and interest it is said that Islam has recognized the profit only in a restricted sense. Because unrestricted and 'abnormal profit' which a capitalist earns is a clear case of exploitation. While Islam recognizes normal profit, it prohibits interest. Unlike interest, profit is the result of productive efforts. In the case of interest, productive effort is not at all made by the lender, but in the case of profit that element remains throughout the process of production and marketing. Thus profit is the reward of progress. In the case of interest, the element of loss is altogether missing because it is fixed and certain, whereas profit is a payment for the a ssumption of risk by the entrepreneurs.

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20 M. Umar Chapra, (in) Muslim World Book Review, (London : Islamic Foundation, 1981), vol.2, p.41.

It is enterpreneur's income which is uncertain and unknown. Because of these vast differences, it is claimed Islam has allowed profit and condemned interest.

Muslim economists, in recent decades, have started to work out different models of Islamic banking, based on profit-sharing instead of interest. Thus profit-sharing is considered as true ideal of Islam.

The proposed 'Islamic bank', it is argued, will work "as a financial intermediary mobilising savings from the public on the basis of mudarabah, and advancing capital to entrepreneurs on the capital advanced by the banks are shared by the banks according to a mutually agreed percentage. The bank also provides a number of familiar banking services against a fee or a commission. The bank's own share capital also goes into its business of offering banking services and advancing capital on a profit-sharing basis. Making allowance for administrative costs, the net revenue on all these counts constitutes business profits, to be distributed over the entire capital involved: public deposits on the bank's share capital. The percentage profits so worked out are then shared with depositors according to a proportion announced in advance. Profits received by the depositors in mudarabah accounts are, therefore, a percentage part of banking profits which mainly accure to the bank as a percentage part of the profits of enterprises financed by it."[21]

Thus, in <u>mudarabah</u> system, instead of interest which is unjust, profit will play the allocative role. The advantage of this system is that the banks as suppliers of investable funds examine the projects presented to them and supply investable funds only when they are fully satisfied that the project will result in the production of a value larger than that invested, since the bank's own returns depend on it.[22] "In the interest based system supply of investable funds by banks involves creation of new money. This applies to the profit-sharing system also. But the creation of new money in profit-sharing system is effectively linked with the genuine possibilities of creating additional value. It may not be so in the interest-based system where credit worthiness of the borrower is more important than the prospective productivity of the project".

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21 M.N. Siddiqi, "Islamic Approaches to Money, Banking and Monetary Policy - A Review". in Ariff., <u>Op.cit</u>., p.30.

22 M.N. Siddiqi, <u>Issues in Islamic Banking</u>, Ch.5., p.127.

Mudarabah : An Analysis

The claim that profit-sharing applied to Islamic banking system, has the unique advantage of not being prone to inflation has been challenged by many economists. It is argued that profit-sharing system offers no solution for inflation. The reasoning is that "in an Islamic economy, where interest is replaced by profit-sharing, the higher the profit share ratio, the lower the demand for liquidity and the greater the velocity of circulation".[23] As the *mudarabah* partnership depends on profit-sharing the profit and interest cannot duplicate each other's role, because in a perfectly competitive markets all profits are normal profits and are, therefore, inadequate to perform the functions of a positive rate of interest. Moreover, profit maximisation under the *mudarabah* will lead to the growth of monopolies and monopolistic market would create economically inefficient allocation of resources both in a static and dynamic market situation. The argument runs thus :

> "Interest rate cannot be abolished just by an administrative fiat, without making alternative arrangements, financial and real

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23 M.A. Khan, Inflation and the Islamic Economy., *Op.cit.*, p. 237.

> to ensure the effective performance of these functions ... since a zero rate of interest is a property of an Islamic economic system and not of capitalism, thus, if interest rate is abolished by an administrative fiat while leaving all other capitalistic institutions intact, the Islamic 'reform' may end up by pushing the economy away from the Islamic ideal. To put this argument formally, while a zero rate of interest is a necessary condition for an Islamic economic order, it is by no means a sufficient condition in that this step, all by itself, need not usher in an Islamic society, based on al-Adl".[24]

The above proposition that elimination of interest will not be a sufficient condition for an ideal Islamic economy, deserves to be considered carefully. He may be right or wrong, but it is fact that there is not any established Islamic economic model available in the Islamic world for empirical studies. Even those "economists" who are full of praise for the mudarabah system, cannot justify their claim merely on scholastic ground. As a matter of fact it has yet to prove its potentiality.

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24 S.N.H. Naqvi, "Interest Rate and International Allocative Efficiency in An Islamic Economy", in Ariff., Op. cit., p.76.

CHAPTER - III

ISLAMIC BANKING

A Historical Background :

The concept of public finance among Muslims goes back to the early Islamic period when Bayt-al Mal-Muslimin (the treasury of Muslims) played an important role in the affairs of the states. The supreme head of the central Bayt-al-Mal was the Caliph himself and his Amir (governer) both being responsible for the smooth running of all the departments under their control. The Caliph distributed the entire revenues according to his own will for purpose of general utility. The chief treasurer was authorised to control all forms of income and expenditure both of the centre and of the provinces. He kept aside the surplus to meet any future emergency and borrowed money to settle debts.

During the time of the Sasanids there lived a group of Christian minority in Madā'in and they were mostly engaged in money-changing business and dealt with Persian silver coins. They migrated to Kutah in the early days of Islam and played an important role in the development of banking organization in Iraq, which seems to have passed to other parts of the world, especially Egypt and Spain, and later on to some parts of Europe. Under the Abbasid the sarraf used to collect gold and silver from people and in exchange give them coins equivalent to the value of the bullions, thus profiting themselves by the difference between the face and instinct value of gold and silver coins. The sarraf also assisted trade by lending money, receiving goods as agents and introducing certain media of credit.[1] In the time of the 'Abbasid Caliph al-Muktadir, (295-320/908-32) however, the Dijahbah[2] emerged as a banker in the modern sense, who, in addition to his functions as an administrator of deposits and as a remitter of funds from place to place, was called upon to advance huge sums to the Caliph and other court officials on credit terms with interest rates and securities. The Dijahabah were mostly christian and jews. By virtue of their vast resources and

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1 S.M. Imamuddin, "Some Aspects of Banking in Medieval Muslim Countries", in Thoughts on Islamic Economics, (Dacca : Islamic Economic Research Bureau, 1979), p.182.

2 A term of persian origin used during the Sasanid administration. It was used in the sense of a financial clerk, expert in matters of coins, skilled money examiner, treasury receiver, government cashier, money changer or collector.

commercial connections these jews and merchants were instrumental in establishing the first state bank in Islamic history (302/913), through which the urgent financial needs of the state could be satisfied. They were given interest on their loans and securities in the form of the tax revenues of the province of Ahwaz.[3]

The early economic history of the Arabs tells us that merchants used to employ not only their own capital, but they had entered into partnership agreements, or had received goods on mudharabah basis. Thus they combined their own resources with those of others or, conversely, made their own capital multiply in the hands of others, with the object of widenning their business activities and spreading the risks. It has been said that the conditions governing trade compelled merchants to carry hard cash with them. When they were on vast distances, they developed the letter of credit.[4] Suftaja which allowed someone to have the necessary sum of money advance to an associate or

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3 See The Encyclopaedia of Islam, p. 382.

4 Suftaja is the Arabicised form of the Persian word saftah meaning paper money as letter of credit. This was a pay order from one man or a bank to another on mutual understanding for a specified sum to be handed over to the bearer of the order by a certain date. Under the Abbasids and Fatimids, it was commonly used in commercial, governments and private transactions. See E.I., p.382.

partner by a third party at some distance places on a reciprocal basis, a procedure which implies the maintenance of regular accounts and correspondence. It was of course also possible to contract ordinary loans and make deposits, and private individuals and government alike made wide use of promissary notes to be used for payments.[5] The state's finance was administered through local treasuries and a central treasury. A central treasury was established in the state's capital and was headed by a treasurer not the head of state. The central treasury had two functions: first to act as a local treasury to the area where it was situated, the capital and its provinces, and second, to act as an organiser among local treasuries. Those treasuries that had surpluses were to forward their surplus to the central treasury in order to meet the needs of the other local treasuries that had defecits, or to receive instructions from the capital treasury to transfer from their surpluses that could meet others' deficits. Some provinces were rich and some were poor, but expenditures were not to be tailored according to the provinces' surpluses. As for the insurance of currency, the central treasury

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5 The Cambridge History of Islam, vol.2 (Cambridge University Press, 1970), p.525.

did not have any function of this kind, it was left to the state as a direct function of its own.[6]

The concept of profit-sharing system, however, is not confined to the Islamic period. The history tells us that in the pre-Islamic period, the method of business finance was in the form of partnership. The differences between partnership before and after the coming of Islam was a difference of sale rather than of principle. While the concept of allocating gains and risk of partners was still the same, partnership after the coming of Islam developed into a larger form so as to embrace a greater number of fund suppliers and entrepreneurs. Capital was divided into small shares which helped investors purchase the number of shares which could afford in accordance with their financial capacity and the degree of risk associated with the investment. This suggests that by the expansion of the state and its economic activities the partnership became a sort of Joint Stock enterprise. However, it can't be rulled out the possibility that interest-based lending might have existed in

6 Ahmad Abdel-Fattah El-Ashker, The Islamic Business Enterprise (Croom Helm: 1987), p.17.

early Islam.[7]

Emergence of Islamic Banks :

The past two decades have witnessed an important development in the field of Islamic Banking. During the 1970s there was spectacular growth both in the number of Islamic banks and in the volume of their global activities. The emergence of substantial balance of payment surpluses in a number of oil exporting countries paved the way for the formation of giant multinational Islamic banks, and helped the spread of Islamic banking in other Muslim countries as well. At the time it was suggested by some financial analysat that this was short lived phenomenon, and that with the drying up of the petro-dollar of the oil exporting countries this would end with a sudden financial collapse. The subsequent events, however, have proved the contrary.[8]

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7 There are evidences to suggest that under a disguised form some tricks of fictitious transactions, such as selling and buying an article simultaneously at different selling and buying prices were practised, see Maxime, Rodinson Islam and Capitalism, tr. by Brian Pearce, 'Suffolk : Allen lane, 1974). The following example illustrates a widely practiced tricks. Person A sells an object to person B for Rs.110, to be paid after a year, but promptly buys it back for Rs.100, payable immediately. While technically no interest payment is involved, this double transaction is equivalent to a single transaction in which A lends Rs.100 to B for one year at 10 per cent.

8 See "Islamic Banking : A Maturing Movement", Inquiry (London) November 1987, p.22.

The present phenomenon of Islamic banking is associated with the rise of the revivalist trend in the Muslim world. Muslims in the field of banking have been looking for legally permissible means of finance, saving and investment. This was the major motive behind the emergence of what is now termed 'Islamic banking'. A second reason is the economic deterioration of the Muslim world, especially in the field of production and project finance, a problem which is severely aggravated by the external debt. The oil-rich Muslim countries have their own 'ailments'. Following the serious oil crisis of the early seventies they were left with accumulated liquidity problems. Banks were needed to provide for the necessary organization of saving and investments. The idea of actually establishing Islamic banks ripened in the same decade. Thirdly, a genuine need on the part of Muslim communities to accentuate and reassert their economic identity moulded itself into political resurgence. The slogan raised included a demand for economic liberation and the application of Islamic principles as the main regulator of legal, economic and social behaviour. An alternative to western economic institution was eagerly sought especially for the third world. The movement for the establishment of Islamic Banks started in the early seventies. It is said that the establishment of Islamic banks started with the accumulation of surplus oil reserve in the petrolium producing countries. This may not be regarded as the sole reason for the emergence of Islamic banks. Firstly, a few Islamic banks had already been established before 1973 when oil prices were increased and the 'so called' petro-dollars' started flowing in the Arab World. Secondly, Islamic banks are not confined to the Gulf region which has been the main recipient of petro-dollars. On the contrary, the Islamic banks have been established even in the countries which have had no share in the oil-price-hike prosperity. Egypt and Sudan, for instance, figure prominently among these countries as both of these have had not one but several Islamic Banks. Nevertheless, the view of linking the establishment of Islamic Banks with oil-price-hike-induced-prosperity cannot be totally ruled out.

Newly found prosperity in certain parts of the Islamic region must have helped in the growth of some Islamic Banks.[9]

As one writer has pointed out the development of Islamic Banking is a recent phenomenon although the idea to establish an interest-free bank goes back to as early as 1940s. However,

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9 Cf., Ausaf Ahmad, Developments and Problems of Islamic Banks, (Jeddah : Islamic Research and Training Institute, 1987).

the conditions then were not ripe for actual establishment of an Islamic banks as not much thought had been given to technical details and actual operation of an Islamic Bank. In fact, the idea of an interest-free-bank remained a blue print for a long time.

A pioneering experiment of putting the principles of Islamic Banking into practice was conducted in Mit-Ghamr in Egypt from 1963 to 1967. The experiment combined the idea of German saving banks with the principle of rural banking. The bank had started in modest way with one room and a staff of twenty five persons. The rural people in that region were religious and would not put their savings into any banks because interest is forbidden in Islam. Moreover, there was hardly any financial institution available to them. Under these circumatances, the emphasis was given to educate the people about the use of banking.[10] T.W. Scharf describes the significance of Mit Ghamr experiment in the following words:

> "The majority of the population had never been dealing with the financial institutions. Because of this, capital

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10 R.K. Ready, "The Egyptian Municipal Saving Bank Project", International Development Review, Vol.9, No.2 (1967), pp. 2-5; in Development and Problems of Islamic Banks by Ausaf Ahmad, (Jeddah : Islamic Research and Training Institute, 1987), p.3

> formation had been impaired. Basically, rural and religious, they tended to distrust bankers operating in western style and, what is more, there were few local branches they could patronize. Since a substantial part of their income was not spent immediately, but put aside for social events, emergency and the like, this idle capital could not be used for productive investment. A precondition, however, for any change of behaviour from hoarding and "real asset saving" to "financial saving" was the creation of financial institutions which would not violate the religious principle of large segements of population. Only then could the rest majority of the population be integrated into the process of capital formation".[11]

Thus, an attempt was made to integrate the rural population into financial system and the development nature of this experiment made it very prominent.[12]

In the Mit Ghamr project, the experiment met unexpected success as saving deposits increased from 25 thousand Egyptian pounds to 125 thousand Egyptian pounds during 1963-1966. During

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11 T. Wholers Scharf, Arabs and Islamic Banks : New Business Partners for Developing Countries, (Paris: OECD, 1983), pp. 79-80; quoted in Ibid., p.3.

12 Volker Nienhaus, "A Western European looks at Islamic Banking", Middle East Business and Banking, Dec., 1982, P.11.

the same period, investment deposits, increased 35,000 Egyptian pounds to 75,000 Egyptian pounds. It also reported that 'the bank functioned on a cautious basis, rejecting, on the average 60% of loan application in the first three years. The default ratio was zero in economically good time.[13]

Although Mit Ghamr project made good start, it had to be abondoned due to certain political factors. Its importance is only historical now. Nevertheless, it paved the way for other Islamic Banks.

The first Islamic Bank in the urban setting was established in Cairo. Nasser social Bank, was established in 1971 and started its operation in 1972. The Bank is a public authority with an autonomous status. Its purpose is mainly social such as granting of interest-free loans for small project on a profit-sharing basis, assistance to poor and needy and loans to needy students for University and higher education. Because of these social functions Nasser social Bank was granted exemption from the banking and credit law of 1957 in its

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13 Shahrukh R. Khan, Profit and Loss Sharing: An Economic Analysis of An Islamic Financial System, Ph.D Dissertation, University of Michigan, 1983, p.207; quoted in Ausaf Ahmad, op. cit.

initial stages. The bank was originally under the Ministry of Treasury but it is now functioning under the Ministry of Social Affairs and Insurance. Its capital came from funds allocated by the President from extra budgetory resources, appropriation from the state budget and contribution of the Ministry of Awkaf etc. Uptill now, various reports on Islamic banking have come cut. The general conclusion drawns regarding the experiments of these banks are rather optimistic.

Currently some western agencies and scholars too, have conducted research in this area, and they have verified that Islamic banks are successful from the standpoint of both owners and client.[14] The records of Islamic banks show that these banks have proved profitable even though they have been offering depositors a higher yield than their interest paying rivals. However, this is not enough point to prove the feasibility of these banks. As one author has pointed out "Before jumping to conclusions about the superiority of Islamic banking over traditional banking, one must consider that in the countries

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14 Ingo., Karsten, "Islam and Financial Intermediation", Staff papers, International Monetary Fund (Washington), vol.29, No.1 (March 1982) and (ii) Wilson, R., Islamic Business: Theory and Practice, Economist Intelligence Unit, 2nd eds. 1985, and (iii) Iqbal, Z., and A. Mirakhor, Islamic Banking (Washington: International Monetary Fund, 1987), Occasional paper No. 49. (vi) Nienhaus Volker, "Banking on contact and co-operation", Arabia (London) July 1984, pp. 46-47.

involved both the dividends of Islamic banks and the interest rates offered by traditional banks are controlled by monetary authorities who may well be under special orders to enhance the actractiveness of the Islamic banks.[15]

A related issue is whether the establishment of Islamic banks may, as some Muslim economists claim, have provided a stimulus to aggregate savings. While there exists no reliable data on the matter, the claim is certainly plausible. This is so because in countries where Islamic banks are in operation the stock market performs inadequately, and, because from the standpoint of the individual saver investor, mudarbah account, serve the same function as stocks. The author thinks that the bulk of the individuals who have switched to Islamic banks are probably relatively less risk-averse savers who would, if the economy were more developed, be holding stocks. He thinks, "If this conjecture

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15 See for a critical analysis, Timur Kuran, 'The Economic System in Contemporary Islamic Thought : Interpretation and Assessment", International Journal of Middle East Studies, Vol. 18, 1986, pp. 135-164. The author argues that since Islamic banks run under the mudarbah and characterstically, mudarbah accounts yield greater returns than interest-bearing accounts. Since mudarbah accounts are riskier, few people would attracted to them they provided higher yields. But it does not follow that every one would became better off all banks were force to offer any mudarbah accounts depositors with a strong preference for security, who currently choose to put their saving in regular accounts in spite of the higher expected earnings in mudarbah accounts, would became worse off it forced to hold a risky patfolio", p. 156.

is correct, one can infer that the establishment of Islamic bankes has stimulated savings by introducing a new financial service. This does not mean, however, that savings could be increased further by abolishing the traditional banking system, for, as noted earlier, the highly risk-averse customers of traditional banks may not feel comfortable with mudarabah".[16]

For a successful Islamic banking, various suggestions, at various conferences, have come out till now. In November 1985 London conference focussed on the different problems and prospects at present found in the Islamic banking institutions. A number of speakers referred to the existing murabaha types of purchase agreement in which the bank buys goods and sells them to the customer at a mark-up. One writer, for example, pointed out that murabaha accounts for around 80 per cent of Islamic banks assets. He said that 'this activity does not add much value to the existing trade financing by conventional banks. He argues

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16 There is a considerable disappointment at the way Islamic banks are operating. Professor Volker Vienihaus of Bochum University, West Germany, points out the disparity between the theory and practice of Islamic banking. He says that 'theory is centred on profit- and loss participations, while the practice shows a preference for transactions bringing set earning for the bank. He has highlighted some of the obstacles confronting Islamic banker, such as a shortage of instruments for the supply of working capital and for very short term placements of funds, and problems owes lender of last resort facilities. See The Middle East (London) November 1987, pp. 36-37.

that it adds to the pressure on the foreign exchange resources of Islamic countries, and accelerate consumption by importing goods which are most non-producing. Murabaha is still considered by many scholars to be the negative side of Islamic banking.

Even during the second decade of its establishment, Islamic banking passed through severe criticism. Although it cannot be denied that the speed with which Islamic banking has spread in the past two decades has surprised many observers and confounded those who initially dismissed it as a passing phenomenon.

The record of Islamic banking so far has proved that there is a great demand from Muslims for the institution where they can deposit their money and borrow in accordance with Shari'ah principles. But impressive though the growth of Islamic banking may be, in terms of the number of institutions and the amount of capital at its disposal, serious doubts remain as whether it will achieve all its aims.[17]

Islamic bankers face the challenge of finding ways in which their system can interact with the western system, dominated

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17 For a controversial discussion of Islamic Bankers; see a report by Salim Hijazi and Susannah Tarbush, "Islamic Banking : A Crisis of Credibility", The Middle East (London) July 1984, pp. 10-14.

by interest (riba). Muslim writers believe that Islamic banking is still in its infancy. It needs to develop a more professional organizational network and a wider client base, especially amongst Muslims. It needs to explain the Shari'ah principle of Islamic banking and finance more thoroughly and convincingly. However, inspite of its infancy, Islamic banking is not restricted to trade financing. Banks, in many of the Islamic countries offer most of the facilities including current account cheque books, and deposit account facilities, plus financial instruments ranging interest-free loan, venture capital, leasing and joint venture, partnership, all under Shari'ah principle. Islamic banking, as some western press, sometimes cast doubts over its existence, is not the 'religious scruples of mullahs', but a genuine expression of muslim desire to invest their money according to their faith. However, the critics of Islamic banking point out that Islamic banking is being established to meet the religious scruples of Mullahs. They say that the Quranic divine threat has proved an adequate deterrent to interest-taking, as if muslim were perfect beings. They also point out that an authorative institution in Islamic banking is missing. In another article which appeared in the 1984 Newsweek reference was made to Turkey's decisions to allow Islamic banks to be set up in the country. The article implied the establishment of Islamic banks is an isolation of Turkey's secular constitution, and accused the Ozal government of forgoing an alliance with Islamic world "that is far too holy".[18]

Types of Islamic Banks :

The Islamic banks may be classified into different categories such as :

(i) Development Bank

(ii) Special purpose Islamic Banks

(iii) Islamic Commercial Banks

(iv) Ownership of the Islamic Banks

It is argued that the main purpose of development bank is to foster the process of social and economic development amongst its members. Usually its clients include various governments. The example of such an Islamic bank is the Islamic Development Bank'.

Some Islamic Banks have been created to fulfil some specific purpose as to serve some special classes of customers. Such banks may be termed special-purpose Islamic Banks and may further be classified as social banks, agricultural banks, industrial banks, etc. One example of such a specialized Bank amongst the existing Islamic Bank is the Nasser social Bank of Egypt which was established in 1971 and started its operation in 1972. Nasser social Bank is a public authority with an autonomous status. The Bank performs certain traditional banking functions such as acceptance of deposits and promotion of saving habits but its main objectives are social, such as introduction of pension and insurance to certain class of people, the granting of financial assistance to persons facing hardship, the granting of interest-free loans to small industrial projects, leading to University and higher institute students etc.

The special purpose Islamic Banks offer a wide scope of their application in the Islamic countries. They have the potential of transforming the social and economic life in muslim countries. For example there, could be a chain of small Islamic saving Banks whose primary function may be to promote small savings. Those Islamic Banks go a long way in mobilising resource for economic development. Similarly Islamic Banks with specific purposes could be established for different sectors and regions. The case of Islamic Bank of western sudan may be cited as an example. The full potential of this type of Islamic banking is yet to be realized.

Islamic Commercial Banks :

The purpose of Islamic commercial Bank is to provide normal commercial banking services in accordance with the Shari'ah. The basic motive behind the operation of these institution conduct only those business activities which are permissible in Shari'ah. These banks offer alternative banking service to those who like to avoid Riba-based banking. Amongst the existing Islamic banks, most are of this type.

Ownership of Islamic Banks :

On the basis of ownership Islamic Banks may be classified into international Islamic Banks, Government owned Islamic Banks, privately owned Islamic Banks, and co-operative Islamic Banks. Among the existing Islamic Banks, the Islamic Development Bank is an International Bank. The Nasser social Bank is a wholly government owned bank and most other banks are privately owned.[19]

Functions of Islamic Banks :

The basic concept of modern Islamic banking is that since interest is forbidden in Islam but profit allowed, one should

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19 Ausaf Ahmad, Development and Problems of Islamic Banks (Jeddah : Islamic Research and Training Institute, Islamic Development Bank, 1987).

develop investment in which one can be a full partner and therefore, cbtain a share of the profit from the transaction. To make matters easy to handle, the partners pool their funds in a partnership which in turn invest the pool in various projects. The partners are also therefore, the depositors. In most Islamic institutions the depositors have the right to leave their funds in the pool far the length of time they desire (as in a traditional bank:) but, naturally they can expect to receive a greater share of the profits the longer they leave their funds. The depositors in the normal course of business will come in or go out of the pool of funds. It is hoped that enough deposits will on the average remain sufficient to continue funding whatever project has been financed. The original capital of the funcing members can make up the shortfalls in deposits if any. Since the depositors are partners they can not have any assurance that their investment will be profitable as far that matter safe. Indeed, it could even be lost.

The various Islamic financial institutions functioning today are carrying out a variety of banking, financing and investment operations on a competitive basis. Their banking system handles current accounts, saving accounts, fixed investments accounts and call investment accounts. Finance is being done in a variety of ways. On a short term basis it is being carried out fer trade acceptance and hire purchase. On medium term basis it covers loans, business development credits and lease financing, on the long term basis it is extended to mortgage, equity financing. International banking services are also available with these institutions for foreign exchange transactions, purchase and sale of currencies, purchase and sale of commodities, transfer of funds, export financing, letter of credits and letter of quarntees. There are some other services also which include safe deposit boxes, security safe keeping services, management of private investment portfolios and trustee functions.

The existing Islamic banks perform a number of functions. Some of these functions are normally performed by the commercial banks and some functions have been modified by Islamic banks because of the constraint that they have to operate in accordance with the Shari'ah. "Although there might be some difference in the performed functions amongs the Islamic bank, it would be difficult to provide a list of functions performed by each bank. The Muslim scholars have created out following important functions of Islamic banks.

i. Opening of accounts for individuals and companies and accepting cash deposits for safe custody and investment both in local and foreign currency.

ii. Giving credit and loans in conformity with Shari'ah.

iii. Purchase and sale of gold bullion.

iv. Purchase and sale of foreign exchange on the spot rate only.

v. Issue of guarantee.

vi. Providing short term financing against collateral in the for form of commercial papers at agreed commercial yield without interest.

vii. Collecting and processing drafts, cheque, promisary notes, bills of lending etc. on commission.

viii. Purchase and sale of shares, certificate of investment financial papers and bonds without interest.

xi. Establishment and management of special funds for socially desirable purpose e.g. investment in trade, agriculture, industry or real estate.

x. Providing finance on the basis of mudarabah.

xi. Providing finance on the basis of Musharikah.

xii. Providing finance on the basis of decreasing participation.

xiii. Operating specified investment account.

xiv. Direct investment by the bank.

xv. Leasing of machines, equipments, apparatus and tools.

xvi. Sale and purchase of real estate.

xvii. Carrying out agency functions by appointing agents and working as agents.

xviii. Sale and purchase for others on a pre-agreed profit basis (Murabahah).

xx. To establish solidarity and security funds in order to cover deficit, in conformity with Islamic law of co-operation.

xxi. To provide technical, economic, financial, management and marketing consultancy services for the preparation of feasibilities studies of project.[20]

Some other functions of Islamic banks might include: financing and establishment of different kinds of projects on behalf of other companies, and on the basis of joint ventures to undertake the development, and promotion of investment in various sectors through the establishment of new projects or development

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20 These functions of Islamic banks have been prepared by comparing the status of a number of banks. Since it is not based entirely on activities of any one bank, the name of banks are not cited; see, Ausaf Ahmad, Development and Problems of Islamic Banks, op. cit.

of existing projects, to mobilize financial resources from local and international money markets in accordance with Shari'ah. However, it is not necessary that each Islamic bank undertake all of the above functions. Working in divergent atmosphere, they may confine themselves to the function most appropriate to them. It must suffice to say, that in general Islamic banks undertake all banking services and all commercial and financial investment on the basis of techniques permissible by Islamic Shari'ah.[21]

The survey on Islamic banking by several scholars has brought out various dimensions, the problems and prospects. The experiments at such a primarily stage, however, can convince a modern economist to believe in the soundness of Islamic banking. One finding by Fahim Khan indicates that none of the Islamic banks has ever provided on interest-free consumption loan, and that the banks are exhibiting a marked preference for investing in "projects which give quick returns".[22]

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21 Ibid., p.16.

22 M. Fahim Khan, "Islamic Banking as Practised Now in the World" in Z. Ahmad Money and Banking in Islam, (Islamabad : Institute of Policy Studies, 1983).

In their report prepared in 1981 under the chairmanship of the governor of the Saudi Monetary Agency, the Islamic Central Bank governors highlighted the following points:

1. The establishment of Islamic banks would reflect the sincere desire of the people of Islamic world to apply the Islamic Shari'ah in different Walks of life.

2. The Islamic banks would help attract deposits and savings for directing them towards productive investments, beneficial to the people and economies of the Islamic countries.

3. Simultaneously, with control and regulation the central banks are required to provide support and assistance to the Islamic banks, so as to nurture their growth and development. It must be appreciated that Islamic banks will be at a considerable disadvantage in facing the competition with riba banks. It will be necessary to ensure that Islamic banks get the necessary financial assistance from the central banks.

4. The central banks of Islamic countries should also foster the development of financial instruments which are interest free, so as to enable the Islamic banks to meet statutory liquidity requirements as also to place excess liquidity to profitable use.[23]

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23 Arabia, (London) May 1984, p.48.

There is general concensus that banking is the most important sector of any financial system. In this regard, putting the emphasis on Islamic banking Mr. Muazzam Ali, who is adviser to the president of Pakistan on Islamic affairs and Vice-Chairman of the Dar al-Maal-al Islami (DMI) and of the International Association of Islamic Bank, says :

> "Until the early part of the 20th century Islamic banking was more or less an abstract concept. Much of what was said and done in this field remained hypothetical. It was not possible for a very long time to initate a programme of practical implementation of Islamic banking on a scale which could produce solution to economic problems confronting the contemporary world.[24]

In December, 1970, when the second Islamic conference of Foreign Ministers was held in Karachi, Pakistan and Egypt jointly sponsored a proposal which called for a study for the establishment of an International Islamic bank of Trade and Development together with a Federation of Islamic Banks. Expert from 18 Islamic countries examined the proposal and prepared their report. It was recommended that the interest-based financial system should be replaced by a system of participation scheme linked with profit and loss sharing. It was decided that a Federation of Islamic

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24 Muazzam Ali, 'Islamic Banking Comes of Age', Arabia (London) August 1985, p.60.

Banks and an International Islamic Bank should be established. The principle on which the proposed bank was to be established were :

1. to finance commercial transactions among Islamic countries,

2. to finance the development and investment institution as appropriate affiliat es,

3. to undertake the necessary transfer, clearing, and settlement among the central institutions of the Islamic banks in Muslim countries as a beginning towards building up un-integrated Islamic economy,

4. to provide central institutions of Muslim countries in pursuing their objectives within the framework of Islamic directives,

5. to administer and utilize zakat funds,

6. to administer the surplus liquid money of these central institutions of the Muslim countries.[25]

As a general practice Islamic banks no longer deal with money or capital only but also with commodities, products and services; they are not only banks but traders too. It is also

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25 Arabia (London) August 1985, p.61.

imaginable that a number of specialized investment companies will come into being offering their services to Islamic banks who could then dispense with their own specialized investment management. In other way, as Nienhaus thinks, these Islamic banks by and large, will become a kind of merchant banks instead of universal commercial banks. Therewith they would resume and continue as old banking tradition of medieval Islamic Near East that was broken not before the middle of the 19th century under the increasing influence of European ideas and power. The evolution of modern Islamic bank might result in financial institutions of a very similar character to those old "merchant-cum-banking enterprise."[26]

Islamic financial institutions have religious advicers or committees who give an opinion on the conformity of procedures with the Shari'ah. In practice there are constant arguments over the very tenets of Islamic banking and the translation of Shari'ah into modern financial practices. Finding acceptable outlet is a major challenge for Islamic institution. Not surprisingly, it is in the field of trade that Islamic banking has made most headway - the Arabian peninsula is historically a trading area and the Prophet was himself a trader.

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26 Nienhaus "Profitibility of Islamic Bank", Journal of Research in Islamic Economics (Jeddah), vol.I, No.2, Writer 1984, p.40.

Islamic banks are constantly trying to find way to diversify their activities without contravening the shari'ah. Dr. Ahmad al-Naggar, Secretary General of the International Association of Islamic Banks. He summarises the main philosophy behind the Islamic banking system and tries to show how it differs from commercial banks which may perhaps not be occupied by many economists. "On the ethical basis, he writes the Islamic banks are governed by the restraints of the divine system while the traditional banks are governed by none other than the logic of competitive market system. On the basis of aims and objective, the Islamic banks, with their dogmatic framework, are a part of a community working in harmony with the other part of the realization of the divine systems. Commercial banks, on the other hand, are an entirely linked to their community only for the realization of profit. In practice, the Islamic banks work in the employment of finances. Money to them is a means for the fulfilment of a function. Hence they use it in trading while the traditional banks work in buying and selling it. To them, money is a commodity in itself and not an intermediate means to procure a commodity. These differences between the Islamic banks and non-Islamic banks are bound to lead to differences in the mechanism of work, work procedures, means and methods even in the quality, specification, traits and ways of thinking of employees.[27]

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27 Ahmad al-Naggar, 'Problems, Successes of Islamic banks', Arabia (London) June 1984, p.46-48.

Conventional banks are becoming increasingly interested in relationship with Islamic institution, and a number have set up units which specialise in providing investment and correspondent banking services. Islamic bankers have yet to show that they can develop from this success at the gross-roots level into breaking the mould of traditional banking on an international scale. A positive step might be the creation of an international Islamic banking society to enable Islamic financial institution to exchange information and get over their suspicions of one another "It would be a pity if feuds are allowed to weaken the Islamic banking movement, for the world debt crisis is forcing a reevaluation of the western financial system and Islamic banking might be able to offer at least a partial alternative.[28] In west, Islamic banking has been looked upon rather with appreciation, some recent seminars have also been held, for example, in London and Paris.

Professor Erik Trolle Schultz, who is the general manager of the Islamic Bank International of Denmark, says that traditional banking system is more than 100 years old and is well-documented. Islamic banking is only a decade old. Although there is a consensus as to what are correct procedure, these are in continuous flux of change. Risk sharing and PLS system form the basis of Islamic banking - in effect it rodes the rock of riba banking that is the dominant role of the bank and its intermediation. This is what banking in the west fear most.[29] Another western, Wnolers-Scharf says :

> "Islamic banking is one of the most original and dynamic concepts to emerge from the south. Islamic bank could play a radical new role in the development of non-oil developing countries through providing risk capital, joint venture capital and trade financing on shari'ah principle.[30]

The current, major obstacles in the growth of Islamic banking as it is generally felt are, the short term liquidity management and the inability of Islamic banks to convert this to medium and long-term investment. And that, Islamic banks and institutions have hardly developed any new instruments of investment and financing. Further, the cooperation with the central banks in Islamic countries and other countries is still non-existent. Almost all the Islamic banks are working under

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30 Actually these views were expressed in the above mentioned seminars where Muslim and western bankers, intellectuals and academics exchanged views on the future cooperation of Islamic banks. The seminar, under the aegis of the Islamic Development Bank and Franco-Arab Chamber of Commerce, attracted top French bankers and business men, see the detail in Arabia (London) June 1984, p.46.

special decrees and are thus obliged to operate under these rules and regulations. The dialogue between Islamic banks and central banks has not developed. Dr. Yones al Tamimi, who is a group co-ordinator of Al-Baraka Group, says in this regard :

> "Our survival depends on co-operation .... Islamic banks have quite a few advantages over the traditional banks — for example, Islamic banks by defination are a combination of commercial, merchant and development banks. This is hardly to be seen in traditional banking. Islamic banks also have structural difficulties and differences".[31]

The main thrust of Islamic Banks are the specific aim of combining high investment returns with social responsibility. But how to achieve this objective ? Islamic banking is also seen as an international banks, which means - it will cooperate with the local Islamic banks by offering international banking services - which of course includes interest-free loans, international investment, technology transfer, trade, commodity and currency trade, besides this — development funding — all based on Shari'ah principle. But how to utilize its collective investment talents and professional expertise to strive for goals. Uptil now, Islamic banks have been viewed sceptically in western banking circles.

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31 "An expanding Al-Baraka merits faith of the Bank of England", Arabia (London) November, 1984, pp. 44-45.

But as the movement gains momentum and respectibility, many top western bankers and financial institutions are reappraising their attitude and are now looking to work with Islamic banks.[32] There is advantage of this contract in the Middle East, growing confidence and expertise, and the resources of its parent company. About the European banking, it is said, is still very conservative and perhaps it will also be watching the new banks performance closely. Although the main problems are those of interest and deposits, European banking also concern itself perhaps too reqorously with style and presentation. However, it will be interesting to see how long major banking centres — such as London, Zurich and Paris, which are extremely populus with Middle Eastern bankers, whether Islamic or not — resist the over-tures of Islamic banks.

Now, most of the Islamic bankers have found in their experiences that competition with conventional bank will be healthy attitude, but cooperation between Islamic banks should be strengthened. One of the coordinator of Al-Barakah group in Jeddah

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32 For example Denmark has become the first European country to grant a full banking licence to an Islamic bank. The Islamic Bank International of Denmark (IBID), a subsidiary of the luxemburg based Islamic banking system International Holding, was its official status from the Danish Central Bank in 1982; see a full report in Arabia March 1983, p.60.

Mr. Younes al Tamimi says that cooperation is a necessary condition. This might help banks deal with the problems of liquidity shortages and surplus, for which adequate instruments have not yet been developed.

Islamic bank is still weak, Tamimi views 'specially when direct trade relations between Islamic countries are limited, and are directed to and conducted by international financial centres", Tamimi also criticises the lack of attention to training.[33]

Investment and merchant banks could act as financial advisers, defining projects, analysing costs and benefits and advising on economic life of projects. In return they would receive findings and management fees. It is suggested that western banking system could cooperate with Islamic banks.

"One of the most important ways in which western and Islamic institutions could work together is in devising new banking instruments that conform with Islamic principles. Trading in

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33 Some Islamic bankers have called for the creation of a Universal Islamic Bank, which would seek collective solution to some of the problems they face. For example, in a conference held in London in November 1985, some bankers had argued that there should be an Islamic financial cooperation rather than a bank, perhaps under the auspices of Islamic Development Bank: See <u>Development And Problems of Islamic Banks</u>, op. cit.

foreign exchange is at present restricted to spot transaction, with a prohibition or forward deals and swaps. Western banks could eventually reap the benefits of the expected huge foreign exchange activity.[34] The careful analysis of the literature on Islamic banking reveals that strong opinion exists over the invention of new instruments and methods to incorporate the spirit of Mudarabah and Shirakah transaction. However, it is accepted that "Muslim Economists have been trying to present the interest-free economy in theoretical models but unless some successful working example is presented to both the businessmen and economists their logic, no matter how convincing, will remain doubtful".[35]

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34 This problem was discussed at a conference on Islamic Banking and Finance held in London (31 October - 1 November) 1985, organised by the Business Research International, 57/61, Martimer Street, London, WIN TTD). Among the speakers were some top Islamic bankers who talked of need for dressing riba banking in Islamic banking terminology so that the existing level of cooperation with western banks can be continued without much political fall out. There were also some dedicated and seasoned Islamic bankers who outlined the problems they were facing and the adoptations they were proposing to enhance the operational range of Islamic banking environment; see a full report by M. Iqbal 'Banking on Islam' Afkar Inquiry (London) vol.2, No.12, December 1985; pp. 32-37.

35 M. Fahim Khan "Islamic Banking as Practised Now in the World", in Ziauddin Ahmad, (ed.) Money and Banking in Islam, Op. cit., p. 259.

<u>Financial Structure of Islamic Banks</u> :

In the Islamic system, the banking finance has some of its own methods. For a long term finance loan may be obtained from the bank to finance a particular investment project or for an over-all investment in the company. Since the bank is not entitled to a fixed return, its return from the loan will be calculated as a share of the company' profit based on the relationship between the funds supplied, the loan, and other funds in the company. If the banks loan is made to finance a particular project in the company, the bank's profit share is calculated on the basis of the profits achieved from this project. The bank's profit share in such a case is not necessarily tied up with profits (or losses) from types of investment projects in the company. In the case of losses, the company's reserves are used to absorb them first, and further extra losses are deducted from the amount of loan, the principal, and in proportion to other funds supplied. Bank loans have a fixed period at the end of which the principal, or what remains after deducing losses, is paid back to the bank.

Islamic banks differ greatly with usual commercial banks in their use of funds. They provide finance on the basis of financial transaction permitted by the Shari'ah. These financial practice include : <u>Mudarabah</u>, <u>musharakah</u>, Deferred sale, <u>Murabahah</u>, ijarah, lease, purchasing financing and Qard Hasan. These financial operations are explained below.

'Mudarabah is a business contract between two parties which own dis-similar resources. One party provides the capital and the other skill and dexterity of trade.

The capital provider shall not involve in actual and day to day operation of business but shall be free to stipulate such conditions as to ensure the best use of this funds. After the expiry of period, which may be in fact the termination of the project or till the return are obtained from the trade, the capital provides shall get back his principal amount along with a share of profit, the ratio of which being determined at the time of agreement, before the beginning of project. In the event of loans, which makes the capital provider eligible for a share in profit. The rational is that capital provider is exposing his capital to business risk and that makes entitled to a share in profit. This is in essence the principle of Mudarabah.

As it is said, the Mudarbah agreement is based on justice as it grants an equal position to both parties of the agreement. This is at least on three counts: firstly, both parties have an equal position in the determination of ratio in which profit shall be shared between them. Secondly, in case of loss, if the provider of capital suffers reduction of his principal amount, the provider of labour is deprived of any reward of his labour, time and efforts. Thirdly, both the parties are treated equally if there is any violation of agreement. If the provider of labours violates any of the stipulated condition, does not work hard or is instrumental in causing loss in business due to negligence and the poor management etc; he will have to bear the responsibility for the safe return of whole amount in question. If, on the other hand, the provider of capital violates any of the stipulated conditions (e.g. he withdraws his money capital before the stipulated time as any other such thing) he will have to pay the investor a reward equivalent to what he would have earned in similar work.[36] In general, Muslim thinkers' view on mudarabah is that of a main component of profit-sharing system. In a recent conference, a co-ordinator of banking affairs of the Al-Baraka Group, Mr. Younes al-Tamimi said that mudarabah accounts for around 80 per cent of Islamic banks assets. According to him:

> "the leading instrument of Islamic banking should be mudarabah, in which the banks provide capital to a project manager and shares in profits. In the case of loss, the bank bears the whole loss, while the manager losses only his efforts.[37]

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36 Ausaf Ahmad, Development and Problems of Islamic Banks, op. cit., Ch. 11.

37 See a full report of his statement in The Middle East (London) December 1985, pp. 22-23.

Tamimi also referred to a third instrument, Musharikah which he divided into two types. The first, equity financing should, in his view, have become one of the principal modes of Islamic banking, yet it accounts for less than five per cent of assets. Second, the provision of working capital is gaining ground and now accounts for about 10 per cent of asset. The use of lease is also increasing and absorb five per cent of assets.[38]

Musharakah :

Islamic banks also provide project finance on the basis of Musharakah. One or two or more entrepreneurs approach the bank for finance and the bank along with other partners provides complete finance. All the partners, including the bank, have the right to participate in the management of project. Any one or all of them also have the right to abandon this right. The profit shall be distributed according to agreed ratios which need not be the same as capital proposition but loss shall have to be shared exactly in the same proportion in which different partners have provided finance. Murabaha or (Bai Muajjal).

'This is a procedure where a partner approaches the banks that certain items (be it commodity or otherwise) be bought for

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38 Ibid., p.23.

him and he agrees to pay the bank. Later on, upon the fulfilment of the actual buying, an agreed percentage of profit. In order to avoid any riba element one of the banks provides that the agreement of the banks and the actual execution of buying do not contribute any legal obligation (according to Shari'ah) on the partner to buy. Hence the risk is still that of banks. Until the partner fulfils his original promise of 'rebuying' the commodity, the risk remains with the banks, which justifies the profit. There is, however, also the practice of financing a mark-up with the binding on buyer to buy the goods. This type of operation is most commonly being used in foreign trade and short-term transactions for purchasing raw materials etc for the industrial establishments.[39] This method has the advantage of simplicity; the provider of finance, which can be the bank, purchases assets, adds a mark-up to the purchase price and sells it to the enterpreneur. Although the method is in conformity with the Shari'ah, it is received with great caution by Islamic bodies. It is feared that the method might open the backdoor for dealing on a fixed interest basis; the mark-up which is determined by the bank might be a mere replacement for interest.

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39 Ziauddin Ahmad, ed. Money and Banking in Islam, (Islamabad; Institute of Policy Studies, 1983), pp. 259-275.

While banks are authorized to change a mark-up within the limits, they cannot charge mark-up on mark-up in the events of delays in repayment; mark-up in view as interest.[40]

While liabilities of an Islamic bank are composed of either current account deposits, on which no profit is distributed by the bank, three broad categories of non-interest modes of financing have been allowed to guide bank's asset operation. First, there is financing by lending, that is, loans, not carrying any interest, on which the banks may recover a service charge, and also Qard Hasan (interest-free loans on compassionate grounds). Second, there is trade related financing, including mark-up, purchase of trade bills, lending on a buy-back basis, leasing, hire purchase, and financing for development of property on the basis of a development charge. Third, lending can take place under investment financing including Musharkah (partnership) equity participation and purchase of shares, participation term certificate, Mudharabah certificates and rent sharing.

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40 For detail analysis see Report of the Council of Islamic Idealogy on the Elimination of Interest From the Economy (Islamabad: Government of Pakistan, Council of Islamic Idealogy, June, 1980).

The following primary financing instruments are now in use.

Participation Term Certificate (PTCs)

This instrument could be used to finance long term investment. These certificates are transferable corporate instruments with a maximum maturity of ten years and allow for temporary partnership or Musharakah. In this way PTCs may be viewed as financial arrangement between a financial institution and the business entity on the basis of profit and loss sharing over the maturity period of the certificate. Funds under a typical PTC arrangement may be obtained either from a single financial institution, including the specialized credit institution. The business entity is expected to pay to the financial institution or bank, provisionally on a semiannual basis, an agreed percentage of anticipated profits with a provision for final adjustment at the end of the financial year. In the event of loss, the financial institution shall refund the share of profit that it had received on a provisional basis. However, the loss sustained by an entity in any accounting year will first be adjusted against the reserves of the company, and remaining loss, if any, shall be covered in the subsequent year by the two parties in agreed proportions. The financial institution is also permitted to convert upto 20 per cent of the principal amount of the PTCs into ordinary shares at par value, so long as funds against PTCs are out-standing lending is secured by a legal mortgage on the fixed assets of the company.[41]

Leasing :

The bank, in this case, purchases a physical capital/ equipment and rents it to its client. This procedure can be converted into a reduced renting procedure whereby the customer, by paying every year an instalment of the value of equipment/ physical capital, reduces the rent, till the whole equipment is owned by him and the rent is eliminated. To the lessor, leasing has the advantage of being less risky than other types of finance in that it provides him with a reasonable profit margin without having to follow the financial records of the lessee enterprise. The cost of usurance of leased assets has to be borne by the lessor in order to make the method acceptable to Islamic law.[42]

Another method of banking finance is 'Investment and auctioning'. In this method, banks and financial institutions

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41 Iqbal, Z., and A. Mirakhor, Islamic Banking, (Washington: International Monetary Fund, 1987); Occasional paper No.49.

42 Ahmad Abdel-Fattah El-Ashker, The Islamic Business Enterprise (London : Croom Helm, 1987), ch.6.

from a consortium and formulate investment project which are auctioned and 'sold' to interested companies at the highest bidding price. In this project, the banks undertake the process of finance by guaranteeing the provision of the required plants and machinery at agreed specification and in accordance with a time schedule. The buyer, the interested investor who may be a company, may be required to finance the working capital; labour expertise and enterpreneurship are the investor's responsibility. This method is under criticism on the ground of legitimacy, and that the fixing of a minimum auction price by the bank's consortium, which may include a profit margin, implies the existence of interest which violates the Islamic principles.[43]

Hire Purchase :

Under this method, banks and other financial institutions can provide funding for the purchase of fixed asset. In addition to the repayment of the original cost price, banks receive a share in the rental value of equipment calculated in proportion to the asset's outstanding share in the company's capital employed;

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43 See for detail, M.N. Siddiqi, The Economic Enterprise in Islam (Lahore : Islamic Publication 1972).

payments to the banks are made in instalment for a period mutually agreed upon at the end of which the title to the equipment is fully transferred to the hiring company.

Business Practices of Islamic Banks :

Keeping in line with the standard practice, business practice of Islamic banks may be classified into two main categories.

(i) Sources of Funds of Islamic Banks

(ii) Uses of Funds by Islamic Banks

(i) Sources of Funds of Islamic Banks:

Like commercial banks, Islamic banks also obtain funds by operating certain type of deposits accounts which are explained below :

(a) Current Account:

The Islamic banks usually accept deposits from individuals and companies for safe custody and for the convenience of customers. The bank requests the permission of customers to use their money so long as it remains with the banks at the bank's own capital. If any profits are generated by the use of money in the current account, they belong completely to the bank. The customers are given the right of withdrawal for the part of or whole of their amount at any time without notice and the bank guarantees to honour all such requests. The banks provide cheque books and services usually connected with the current account.[44] Thus, current account may be offered in the conventional banking owners of funds to do so.

(b) Saving Accounts:

Although all Islamic banks operate saving accounts, there are significant differences in their implementation and operation. In this respect, the theoretical formulation, which defines the saving deposits in the following way.

> The bank accepts deposits from its customers looking for safe custody of their funds and a degree of convenience in their use together with the possibility of some profits in the form of saving accounts on the principle of Al-Wadiah. The Bank requests permission to use these funds so long as these funds remain with the bank. They can withdraw the balance at any time they so desire, and the Bank guarantee the refund of such balances. All the profits generated by the bank-from the use of such funds belongs

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44 In technical language of Islamic Jurisprudence, these deposits are Amanah and the banks do not have authority to use them unless they obtain the specific permission of the banking tradition. Customers are supposed to give their explicit approval to the bank to use their funds, without any return. The bank however, should guarantee payment of these funds on demand.

> to the portion of the Bank. However, in contrast with current accounts the bank may at its absolute discreation reward the customers by returning a portion of the profits generated from the use of their funds from time to time.[45]

It may be pointed out here that any return to money capital is Islamically justified only if it participates in the risk. If the saving depositors are guaranteed that amounts will be refunded in full, if and when they want them, they are not participation in the risks. Then how can a reward to saving depositors are not Islamically entitled to any return. If the bank refunds some portion of its profits generated from the use of saving deposits, it is absolutely at the discretion of the bank and it must be treated as gift'.[46]

Saving Accounts :

No return is expected in these accounts and customers may draw their funds any time without notice. The bank guarantees

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45 I have quoted this from Ausaf Ahmad's summary of Bank Islam Malaysia, Berhad: Organization and Operation, pp. 11-12.

46 Contrast to this, the Bahrain Islamic Bank calls it saving account with authorization to invest. The depositors put their money and provide the bank with an authorization to invest it. The depositors are allowed the right of withdrawal but profits are calculated on the minimum balance maintained for a month. See "Bahrain Islamic Bank, Goals and Function" (Arabia). The Jordan Islamic Bank has taken yet another way. It includes the saving accounts into the joint investment account. See Jordan Islamic Bank: Annual Report, 1981, p.25; Quoted from Ausaf Ahmad, op. cit.

the return of fund from these accounts on demand. However, since the bank can only keep part of these funds in cash to meet demands and use the rest in other activities, it may also render this service without charge.

Investment Accounts :

The investment account in the Islamic banks is the counterpart of fixed deposits. These accounts are meant for those customers who are looking for investment opportunities. Usually, the period of account is specific by the banks. Most Islamic banks accept funds for a specific period ranging from one month to five years. Generally speaking, the depositors do not have right of withdrawl in this type of account. However, withdrawal may be allowed in exceptional circumstances in which case the depositors will have to forego their shares of profit for the withdrawan amount.

In some cases, investment accounts are accepted for the specified period only, which is decided by the mutual consent of the bank and depositors. The investment accounts are operated on the basis of mudarabah. In this case, the bank acts as the 'entrepreneure' mudarabah and the customer as the 'provider of capital' (Rabbu al-mal). Both parties agree, interalia, on the proportion, in which profits are to be shared.[47]

These accounts reflect a departure from the conventional banking system.Customers will be encouraged to deposit their funds in investment accounts on the basis of a pre-determined profit-sharing ratio for a specified minimum period. The profit-sharing ratio is usually pre-determined according to the nature of deposits accounts, whether the distribution of profit is considered on a short or long-term basis. The long term deposit accounts usually have higher profit-sharing ratio because they are more stable and the banks may use the funds for long-term investment. Although depositors (of short and long term) can demand their funds whenever they like, to share in the profits (or losses), they

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47 The Bahrain Islamic Bank and Kuwait Finance House have worked out yet another system of investment accounts. The investments deposits are classified into two categories : (i) Limited period deposit (ii) Unlimited period deposit. The limited period investment deposits are accepted for a specified period which may be determined by the mutual consent of depositor and the bank. The contract terminates at the expiry of the period; but profits are distributed and accounted at the end of the financial year.

In the case of unlimited period investment deposits, the period is not specified. These deposits are automatically renewable unless 3 months notice is given. The profits are calculated and distributed at the end of the financial year. No withdrawal or increase are permitted in this kind of account but customers are allowed to open more than one account. See Development and Problems of Islamic Banks, op. cit.

must keep their money in the bank atleast for the contracted period. So for example, no profit-share would be given for a six months deposit accounts if the depositors withdraw the funds after only five months. This feature exposes the bank to even higher liquidity risk if losses are expected, and to alleviate this risk the bank may require that notices be given before withdrawls are allowed.

(d) Special Investment Accounts :

Islamic banks also accept special deposits for investment either from individuals or from companies corporation, or even from governments. The purpose, terms, condition and mode of investments of these deposits may be decided by mutual consents. Investment in Islam is conducted in such a way as if reflects courage, tolerance and mercy, if it had to represent sincerely the humanistic views of Islam. That, however, should not violate the strict and serious principles of economy, that money should be invested in productive sectors and that investment should not run contrary to the well-being of the community. Money in the interest system remains uneffected and indifferent as to how it is used as long as the investor is certain that his money and profit will be paid back. Islamic investment that is based on profit, sharing does infact, result in reducing the final cost of production that is because the cost, here, is free of interest. Goods produced under the Islamic system would be cheaper for the consumer than the same goods being produced under the interest system. The producer on the other hand, is not disadvantaged because he, in case of exporting, will find better chances for profit since his prices will be lower than his competit ors. Thus the money supplier, the consumer, and the producers are profiting in an Islamic non-interest economic system.[48]

Expansion of Islamic Banks :

Islamic banks are not confined to any specific geographical region. They are located in the Arab World as well as in the non-Arab World. These are Islamic banks in the capital surplus economies as well as labour-surplus economies. They are spread in poor as well as in rich countries. Thus, Islamic banks are well-diversified despite their small number.[49]

There are eight Islamic banking Institutions which are located in non-Muslim countries. These countries are Switzerland,

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48 "Profiting all by the use of Non-riba" Arabia (London) January 1985, p.62.

49 For a country-wise numbers of Islamic banks see appendix - I.

Luxembourg, Denmark, Phillippines, England, South Africa and Bahamas. All these countries have one Islamic banking Institution except England which has two. Arab world has 17 Islamic banks, cther banks are located in the non-Arab Muslim countries. With the Arab world Sudan has the maximum number of Islamic banks; (4) while Bahrain and Egypt each have three Islamic Institutions. Thus, Islamic banks are spread over muslim and non-muslim countries. Two countries, Pakistan and Iran have not been included in this category as they have Islamised their economies and their banking system is operating fully under the Islamic principles.[50] On the other hand, in Saudi Arabia, though the banking structure is still based on interest, but Al-Rajhi Banking and Investment Corporation is now converting from a money changer into a full service Islamic banks. It has the largest number of branches of any bank in the Kingdom, and

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50 For comprehensive report see Iqbal Z and A. Mirakhor, Islamic Banking (Washington: International Monetary Fund, 1987).

now considered as the biggest challenge to be faced by the Saudia banking system.[51]

Thus, this brief account holds altogether that recent spread of Islamic banks is not merely a passing phenomenon. There is constant emphasis that the theory of Islamic banking should be understood within the general framework of money, finance and development.

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51 See, MEES (London), 20 June 1988. The Islamic financial institutions which were first started in the Middle East, quickly tried to develop activities outside the Muslim world. Dar Al Mal Islami tried to obtain a licence to open in London and thus gain a certain degree of responsibility among the western financial markets. However, the application was turned down by the Central Bank of England. The governor of the Central Bank was quoted by Arab Banking and Finance in November 1984 as saying: Although Islamic banking tenets provided a perfectly acceptable mode of investments, they did not find within long-establishment, well understood defination of what constitutes banking in U.K. The article want on saying that 'the point he made was that western banking regulations insisted on capital based security for depositors. Moreover, deposits were not regarded as liabilities on an Islamic bank's balance-sheet. The depositors had to take part in all the risks and profits and losses of institutions. The governor of the Central Bank of England did not mention the question which had been raised in the financial community about the management and goals of the Dar-Al-Mal-group.

On the theoretical level, Islamic banking is faced by many problems that work together to hinder its realisation. Crucial among these problems is the fact that the implementation of Philosophy is far beyond the capacity of any one bank alone. There is a need for a comprehensive interaction of many Islamic institutions in fully fledged Islamic environment. Even if the Islamic bank is functioning on the national level, in a completely Islamic environment, its transactions with non-Islamic banks abroad would cause many headaches — for of course the Islamic economy cannot be a simple close one. To achieve this idea the Islamisation of the Islamic banks should go hand in hand with an over all Islamisation process. This is the only guarantee for the efficiency and viability of Islamic banking models.

CHAPTER - IV

PROBLEMS AND PROSPECTS OF ISLAMIC BANKING

The purpose of this chapter is to discuss some of the complex problems which the Islamic banking system is facing. Some of these problems are bank specific such as the theoretical issues relating to Islamic banking are still unresolved. There is another set of problems which arises out of the fact that these banks are 'Islamic' with an specific aim; to promote social and economic development in Muslim countries. What is important is that most of these banks are privately owned, working along with the interest-based banking system. In this regard, critics argue that introducing interest-free institution into the current capitalist system of finance is not less than a novel innovation within the system.

The aims and objectives of Islamic banking system and how much these are different from the prevailing system have always been the central debate among Muslim scholars. Some of them propose that an Islamic financial institution should be truely 'revolutionary'. It should not try to manoeuvre with the system for maximum advantage but should try to alter the whole system.[1]

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1 Ahmad Al-Naggar, "Problems, Successes of Islamic Banks", Arabia (London) June 1984, p.46.

The development of Islamic banking in some Muslim countries is facing some other obstacles. In some countries, Islamic banks have to keep a certain portion of their deposit, with the central banks. If this ratio is very high, it may have adversely affected the expansions and development of these banks. Such a high ratio in the central bank put a drain on the resource of Islamic banks in the sense that it could be used profitably if it remained in the Islamic banks.[2] Uptill now various reports and studies done on the performance of Islamic banking indicate that some of the problems and difficulties in its progress are: firstly, the Islamic banks still perform their duties in economic, administrative, legal, cultural and social situations where non-Islamic features prevail. Secondly, Islamic banks follow a system, a philosophy and practices which do not meet with nor run parallel to the practices of hundred of western banks surrounding them and living with them in the same community. Thirdly, there are legal problems such as the laws of those countries where Islamic banks operate require that banking should not be the subject of any risks. Their loans stipulate certain restrictions in this respect.

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2 See the current survey done by an Indian economist, Ausaf Ahmad, Development and Problems of Islamic Banks', (Jeddah: Islamic Research and Training Institute, 1987).

Fourthly, there are some theological difficulties where opinions diverge and unanimity is difficult to attain. Thus there is little co-ordination among Islamic banks in this respect. Finally, the one pertinent issue is that the nature of investment at present found with Islamic banks. Scholars have cautioned that short-term portfolios adopted by Islamic banks is dangerous for the system as a whole. They also feel that there is a problem of obtaining fast investment of liquid cash when available and the prompt arrangement when needed.[3]

The mechanism of Islamic bank is based on investment through partnership and requires a certain period of time for the study of the project to finance. In a survey it has been found that Islamic banks invest generally in the project with quick returns. This is because the banks have to pay a sizeable profit every year on the deposits and they cannot afford to have no profit for some time if they are competing with the interest-based banks. This means that long projects are not likely to be picked-up by these banks. If this is true then this is not only reducing the long run efficiency of Islamic

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3Abbas Mirakhor, "Analysis of Short-term Asset Concentration in Islamic Banking", IMF Working Paper (Washington) International Monetary Fund, October 1987.

banks but will also effect the growth in developing countries if there are no banks to finance such deposits.[4] Hardly anyone disagrees that to shift to an interest-free system, one of the crucial requirements will be to develop an institutional framework that can provide adequate financing for long term.

Some economists in their studies have found that there are two main tasks for the Islamic banks management: The first is the protection against "too optimistic" expectation and resulting damage in the bank's proceed from profit-sharing financing. Secondly, the opening up of new innovative opportunities for high profitable engagements. According to them, an interest bank can often standardise its credit investigation and confine itself to an examination of the securities for credit. But an Islamic bank can hardly ever resign on additional examination of the profit calculation, since its revenues are not fixed and independent of entrepreneural profit but depend on them directly. The problem with these examination is not so much one of calculation techniques but one of well founded knowledge in those markets wherein the entrepreneurial partners intend an engagement with

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4 M. Fahim Khan, "Islamic Banking as Practiced Now in the World", in Ziauddin Ahmad,ed. Money and Banking in Islam, (Islamabad: Institute of Policy Studies, 1983), pp. 259-276.

their investment projects.[5]

Ahmad El-Najjar, the Secretary General of the International Association of Islamic Banks, mentions several obstacles in the progress of Islamic banks. According to him the major obstacles which the Islamic banks are facing can be removed by greater cooperation and persistence to encounter such problems. These difficulties stem from, firstly, the circumstances created by their existence in places and regions where they operate in an economic, legal administrative, cultural and social atmosphere of a non-Islamic nature. Secondly, their existence as a minority institution in the states where they operate. In a country where hundreds of other conventional banks exist; there may be only just one, two or atleast three Islamic banks. Thirdly, from following a unique practice that neither be coverage nor can be assimilated within the system, philosophy or practice of hundred of Non-Islamic banks.

Naggar rightly thinks that Islamic banks have their own conceptual mainspring - defining the objectives, procedures and

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5 Volker Nienhaus, "Profitability of Islamic Banks", Journal of Research in Islamic Economics (Jeddah) Vol.1, No.2, Winter 1984, p.14; Also by the same writer "Islamic Banks - A short History", Islam and the Modern Age, (New Delhi), Vol. X-IV, No.1, 1983.

practices in which they are involved. But there is hardly any collison with hundreds of non-Islamic banks which co-exist with them. However, he makes a distinction between two systems of banking. Unlike the Islamic banks, the existing non-Islamic banks originally germinated in Europe, with the prime concern to gain control over resources and livelihood of people, through the utilisation of funds. Hence, the realisation of these two factors justified the adoption of any means or methods available serving that purpose.[6] Islamic writers put much emphasis on the objective side of the Islamic banks. That is, unlike the Western commercial banking system, Islamic banks are "governed by controls derived from Allah's course', while conventional bankers are controlled only by hard competition. In this regard Ahmad El-Naggar believes that Islamic banks constitute an integral part of society, in harmony with its other constituents' on the march towards achieving 'Allah's course' while commercial banks

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6 Islamic writer's' major objection towards existing commercial banking is that it depends on the philosophy of trading in money based on regarding money as a commodity. The commercial banks demand a price before funds render their function and here lies, as they argue, the essence of the riba or usurious system and source of much of the flaws and mal-functions of the money system. For a detailed treatment of Islamic concept of money and Banking see, M. Umar Chapra, 'Money and Banking in an Islamic Economy', in Monetary and Fiscal Economics of Islam, ed., by Mohammad Ariff (Jeddah : International Centre for Research in Islamic Economics, King Abdul Aziz University, 1982), pp. 145-76.

are not related to their own society except through profit making. In practice, Islamic banks work in the field of investment as they hold the belief that money is but a means to an end. Hence they do not trade in it. Conventional banks work in buying and selling money which they treat as a commodity and not as a medium of exchange. This gap between the two broadens dramatically when it comes to their objectives. Contrary to this objective is the final goal of the conventional banks crystallised in realising profit even when it is gained at the expense of man. These differences between Islamic and non-Islamic banks will necessarily lead to other variances in relation to operational mechanism, methods adopted, style and procedures.[7] Another problem Islamic banks face in their localities is that of a legal nature. Due to the regional or local laws in the countries where these Islamic banks operate. They may expose to risks in the course of under-taking its activities. Some of the problems faced by Islamic banks stem from the lack of a well defined legal system specifying the domain and limitations property rights and contracts that fully correspond to the established banking system and Islamic law. This strengthen the environment of uncertanity,

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7 Ahmad El Naggar, "Islamic Banks: achievements, and obstruction in focus", Arabia (London) March 1986, pp. 68-69.

limit long term investment, and force the banking system to concentrate its asset portfolios in short term transactions. Similar problems relating to legal framework is the Islamic jurisprudence which lacks consensus. A recent study by IMF says: 'that these problems' appear in different form in two countries i.e. Pakistan and Iran. In Pakistan as is mentioned, it has forced the government to establish special banking tribunals to deal with contract on Islamic modes, since the regular court system, as well as existing contracts and corporate laws cannot handle Islamic based contracts. According to the study this is a short term remedy, and problem will continue to persist and become more complex untill the legal system and the underlying corporate and contract laws have become more attuned to the legal requirement of the new banking system. Iran in the Islamic Republic of Iran, where legal system is fundamentally based on Islamic law, the difficulty lies in the absence of a legislative defination of rights and limitations of private property which would explicitly determine the extent and intensity of the private enterprise activities in the economy.[8]

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8 For a brilliant report on Islamic banking in Iran and Pakistan; Zubair Iqbal and Abbas Mirakhor, Islamic Banking, (Washington: International Monetary Fund 1987), Occasional paper No.49.

Liquidity problem is also a big hindrance to be overcome by Islamic banks. Because the operation of Islamic banks is mainly based on financing through Musharikah (participation) an adequate span of time is required during which the study of the project is finalised, and funds are naturally highly illiquid. Now the challenge for the Muslim writers is to develop a programme for the study of Islamic finance which relies only on the Qur'an and the Sunnah. So far Muslim writers have merely borrowed empty economic boxes from the West and filled them with ideas which are Islamic in appearance.

Ghaisem Salehkhow, the executive director of the International Monetary Fund finds some pertinent obstacles that are on the way of Islamic banking. He says that most difficult obstacle for the Muslim writers is the diversity of political system adopted by Muslim countries. Muslim regimes are so diverse that they cannot even present a united front to their enemies. This, more than any other difficulty, hinders the task of introducing an Islamic social system. Islamic measures are introduced merely to serve political exigencies, and are not the result of a considered Islamic philosophy.

An obstacle in the progress of Islamic banks is wholly psychological. Najjar says that usurious mentality is still controlling the attitude of most people. The depositors expect a yield, at least equal to the usurious interest if not more. The financed client is also expected to pay a yield equal to or more than usurious interest rate. Only a minority will commit to the priority of religious legality and alter obstinance from prohibitions few only realize the pioneering role rendered by the Islamic financial institutions of banks for the application of 'Allah's courses' in an investment completely conflicting with the principles they are based on. According to Ahmad El-Najjar:

> 'There are no barriers or obstacles, no matter how complex and multifarious, that can obstruct noble faith and unfailing persistance in applying Allah's course. Secondly, that all banks are called upon to exert more case, attention and moral responsibility to the future development of Islamic banking. Thirdly, both Islamic banks and their associations are responsible for paying more concern to the publication of Islamic banks and to the classification and explication of their objectives and activities. Fourthly, that public media, in Islamic countries should be urged to give more attention to right enlightment with regard to the goals of Islamic banks and the sole they under-take in realising the development of our Islamic communities and lastly, that government of all Islamic countries should be requested to devote more attention to Islamic banks and in particular with regard to the organisation of the

> connection of Islamic banks with central banks and monetary authorities.[9]

Another common obstacle is the misunderstanding that the abolition of riba will establish an Islamic banking system. Even then a successful Islamic banking system would not inevitably usher in a new Islamic social order. The existence of any type of injustice in the name of economic or social progress invalidates any claim to be truely Islamic. Some even go so far as to deny that the disruption of commercial banking has never been the aim of Islamic banking and that to liberate the banks from interest rates is Islamic objective. They even claim that it would be in the interest of commercial banks to allow Islamic banks to flourish.[10]

It is a common complaint among some Islamic writers that Muslim countries have developed expensive life-style which are not

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9 Ahmad El-Naggar, "Islamic Banks : achievements and obstructions in focus", Arabia (London), March 1985, p.68. The author hints that Islamic banks have achieved a lot of progress hitherto, having offered several practical models to ensure and emphasise the validity of Islamic application in the field of financial transaction. The establishment of the International Association of Islamic Banks, and the higher body of Fatwa and Shari'ah supervision can also be counted among their achievements. On the top of that they have realised that the establishment of a number of specialized institutes and training centres for the study and application of Islamic principles in the economy.

10 Islamic Banking : the theory behind the practice", Arabia, (London), September 1986, p.43.

keeping with their values as their resource endowments and conspicuous consumption leads not only to corruption but also unhealthy monetary expansion, inflation, balance of payment deficits and a heavy debt servicing burden. In this regard M. Umer Chapra says :

> An important reform in the reduction of governments wasteful spending without this reduction they cannot fight corruption or minimise their internal or external borrowing and deficit financing. However, the problem is that when governments are able to resart to interest-based borrowing they are under no compulsion to reduce their spending. The abolition of riba should force them to explore all possible ways of economising so that they realise maximum benefits with minimum spending.[11]

An interest-free economy is prone to a number of problems. The adverse public reaction to losses suffered by financial institution; the availability of very short-term loans not amenable to profit and loss-sharing; instalment credit; and government borrowing needs. These problems are of domestic nature but even at international level most countries are

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11"Banking Practice and life-style", Arabia (London) November 1985, p.65.

burdened by a heavy foreign debt. They have to continue to service this debt and to borrow in order to finance their deficit.

Some exponents of Islamic banking believe that banking system cannot succeed unless all the political and socio-economic forces of an Islamic country are made to converge in this direction. Given this convergence, the banking system can be reformed to make a rich contribution. The rationale behind the idea is that since the deposits held by the banks belong to the public, credit should be allocated in such a way that it helps realise general social welfare. This can be attained by ensuring that 'Credit allocation leads to an optimum production, import and distribution of goods and services needed by the majority of society, and that benefit of credit goes to an optimum number of businesses'. These writers advocate socio-economic reform and give much emphasis to the moral uplift of Muslim society. They argue that "To talk of Islamisation without moral reform would be absurd. This does not mean that we should not abolish riba untill society has been morally reformed; the two can be under-taken simultaneously. This will, however, necessitate a gradual movement towards Islamisation.[12]

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12 'Islamic Banking File', interview to Arabia (London) November 1985, pp. 65-66. According to author, another important reform is to inculcate people with the habits of simple living and the moreover, the reduction of government's wasteful spending.

They are in continuous search to find out ways and means to achieve an interest-free economic system. A number of books have been written on interest-free banking; but the economy as a whole, has been given little attention. There is a view that operation of an interest-free economy is far more complex than the operation of individual interest-free banks. Umar Chapra, a leading Pakistani exponent of Islamic banking says that implementation of Islamic economy is rather a complex issue, because complexity arises from the necessity of realising the socio-economic goals of Islam. This cannot be realised unless there is an equitable distribution of income and wealth, and in fulfilling the needs of all individuals in society. The conventional banking system has been a major cause of the concentration of income and wealth. It has also contributed significantly to an expansion of necessary wants and the diversion of scarce resources towards their satisfaction, thus leaving insufficient resource for need fulfilment. The Islamic system should, in sharp contrast with this, reflect the ethic, values and goals of Islam.[13]

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13 His book Towards a Just Monetary System discusses the impact of prohibition of interest on the economy, and attempts to find answers to the problems possed by the creation of a fully Islamised economy. Thsi book answers a number of questions about an interest-free economy that have not been adequately answered so far. Some of these questions, for example, are: what is the rationale behind the prohibition of riba? Can an economy run efficiently without interest? What will be the impact of the abolition of riba on resource allocation, savings and investment, economic stability and economic growth? What are the changes that will have to be introduced in the nature and operation of central and commercial banks? What are the auxiliary institutions which will need to be established in an Islamic economy? How will monetary policy be conducted? What are the new tools of monetary policy that will have to be developed? What reforms would have to be introduced in the social and economic lives of Muslim countries to enable the Islamic system to function effectively and to help to actualise the socio-economic goals of Islam.

When there is a question of changing the whole system, these issues have to be settled in advance. One burning issue is that of service charge by Islamic banks. There is still a debate whether a service charge be levied on pure loans. If the answer is in affirmative' how this is to be calculated and what direct and indirect costs need to be calculated in the calculation of this charge. How to envisage the cost in future without involving the interest element. This is a problem which both the Islamic Development Bank and the Islamic commercial banks will have to face when they advance pure loan. Another issue that muslim writers raise is 'how to decide a margin of profit in trading i.e. if a bank is supplying money to buy some merchandise, should it or should not it charge any profit on it and if the answer is in affirmative, what should be the rate of profit? In many cases such purchase may be a riskless. If this is true then can the mark-up charged by the bank be considered as profit and not riba ? "How should the rent of physical capital be calculated so that it does not include the interest element ?[14]

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14 M. Fahim Khan, 'Islamic Banking as Practised now in the world', op. cit., p. 274.

Use of Funds by Islamic Banks :

Some of the Islamic banks are facing the problem of surplus liquid funds. The exact magnitude of this problem is not known with certainty, but it is believed in the Islamic banking circles that the problem of excess liquidity is quite serious. This problem is in fact the result of the situation that construction loan in which some of the Islamic bank participated through Murabahah operations and realized "quick" profits is over and there are no more avenues for productive investment in the economy. The growth in the resources of Islamic banks and reduction in the demand for credit due to recession of the Gulf region have been identified as two main reasons for excess liquidity problem in the Islamic Bank.[15]

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15 In 1980, the Islamic Development Bank introduced an investment deposit scheme whose main purpose was to raise resources of the Bank and to offer an investment scheme to prospective investors that functions in conformity with the Shari'ah and provides reasonable return to investors. The proceeds of investment deposit scheme are invested in the foreign trade financing scheme which is short-term by its very nature. The investment deposit scheme became very popular and a number of Islamic banks deposited their surplus liquid funds with the IDB in this scheme. The total deposit in the investment deposit scheme grew at a fast rate. Consequently IDB had to refuse some of the deposits under this scheme. In the present circumstances, the capacity of IDB to absorb deposits is constrained by its very liquid position. Therefore, a number of alternatives are being explored at the IDB as well as at the level of Islamic banks. One suggestion is that foreign trade financing operation in which IDB bears all the risk, should be modified in such a way that depositors (Islamic Banks) also share the risk of foreign trade financing. In effect, the proposal is that contract between IDB and depositors of investment deposit scheme should be modified from Mudarabah to Musharkah in which all parties share risks. This will increase IDB's capacity to absorb deposits. For details see, Ausaf Ahmad, Development and Problems of Islamic Bank; op. cit., p.65.

It has been pointed out that areas of possible cooperation between non-riba banking and western banking is the growing surpluses of some Islamic countries. For the last three hundred years, the process of capital money flow has been virtually dominated by Western institutions. As entrepreneurs and governments in third world countries obtain money capital from banks. The banks are in a position to influence the allocation of resources in the society. Thus the more vital interests of society - related to the level of economic activity, allocation of resources and the value of money - are liable to be handled either for the goods of the society or to its determinant by international banks. This is true even though local banking is controlled by indigenous banks. Therefore, because of the large surpluses of Islamic oil-producing countries, their economic future came to be viewed as dependent upon the way Western financial institutions performed their main functions as financial intermediaries and keepers of deposits. Historically, commercial banks have performed this function on the basis of fixed-interest payments; therefore, interest payments formed the basis upon which the banks dealt with depositors as well as the entrepreneurs to whom it advanced money capital.[16]

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16 Khalid Abdullah Tariq al-Mansour, "The Impact of Islamic Economics", Arabia (London) November 1984, p.59.

Every society needs a mechanism through which savings and surpluses can be channelled to investors on the basis of some understanding regarding payments and returns. When society was relatively homogenous, the knowledge and communication between its members in respect to preference relating to risks, liquidity and repayment periods made barter or direct transactions satisfactory. As society became more complex and communication less efficient, the emergence of banks and insurance companies as financial intermediaries became both natural and logical. Accordingly, financial institutions continued to evolve until services such as safe deposits, checking facilities, easy transfers, overdraft, guarantees and agency functions in respect of purchase and sale, payment and receipt, and management and trust deposits became an integral part of modern banking. At the same time, as modern governments and private savers discovered that they need only a fraction of their assets at any one time, they opted to retain the balance with selected financial institutions. These institutions on the other hand found it desirable and profitable to retain a fraction of the deposits as a reserve, and advanced the remainder to other private and public borrowers who desired money capital for various periods of time. As borrowers used this money, new incomes were generated, bank deposit increased, and the same process started again. The results were the "creation of money" and an increase in money supply.

Some of the macto-economic benefits are visualised in the Islamic system. A large number of funds, which at present remain immobilised in Muslim countries would become available for productive investment. The ability of small and medium entrepreneurs to obtain financing would bring to the services of nation a large reservior of entrepreneurial skill which would otherwise remain dormant for lack of resources. And the participation of banks in the losses of business financed will make them more careful in evaluating loan applications through the participation of banks in the success of business, greater information, skill and expertise should become available to business, thus making them more efficient and productive.[17]

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17 In an interview, a Muslim apologetic discusses the problems posed by the creation of a fully Islamised economy. He emphasises this points that in an Islamic economy there will have to be substantial changes in the life-style of Muslim countries and also in the nature and operations of commercial and central banks. He puts his argument: "We will have to change our life-styles, reduce our claims on resources and our dependence on borrowing. Moreover, we will have to introduce changes in monetary policy, we will also have to establish a number of auxiliary institutions to help the commercial banks and financiaries in their task of evaluating projects and auditing. "Banking Practice and Life Style", Arabia (London), November 1985, p.66.

A survey made about Islamic banks indicates that at present, the Islamic banks have a narrow and rather limited sphere of operations. Their portfolio structure is not well diversified. In the beginning of experiment with Islamic banking, it was necessary for the banks to choose "less risky and quick returns" type of investment projects for a variety of reasons. It would bring back the principal amount, generate profit and give access to resources for further expansion. It was also instrumental in bringing confidence among the managers and succeeded in showing to the general public the over all feasibility and viability of Islamic banking. Consequently, the Islamic banks concentrated investment in trade, real estate and construction etc. so-called "soft-areas" of credit. Although some of the Islamic banks have been undertaking equity participation in agriculture and industry, the number of such banks is very small. The problem is that the Islamic banks should come out of safe postures of "soft-investment" and invest in socially desirable long-term investment project.[18]

According to questionnaire prepared by the writer, Islamic banks have made satisfactory progress in the last few years. All the banks singled out providing alternatives to interest-based

18 Cf., Ausaf Ahmad, op. cit., p.14.

banking, efficiency and honesty as three most important reasons for their success; support of government and official agencies was mentioned by only three banks and only one bank referred to higher rate of return to investment.[19]

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19 Ausaf Ahmad, a defender of Islamic Banking writes that all except one bank which is in western Europe' was ambitious to open branches in rural areas and agreed with the statement that Islamic bank in rural areas could serve a useful functions by mobilizing resources for economic development. Five banks felt that their investment portfolios was well-diversified while three banks accepted that their's was not. Six bank reported that they had a problem of excess liquidity, the other two said that they had no such problem. Amongst the six banks which have excess liquidity problem, one bank thought it to be very serious, two described the situation to be serious and for three banks it was not a source of serious concern. Excess of deposits, shortage of investment avenues, absence of long term investment opportunities, policy of central bank, and absence of very short term financial instrument etc. were pointed out as the factors responsible for the excess liquidity situation. For participation in productive ventures, Islamic banks were presented four alternatives : (1) involvement in management (ii) participation in supervision (iii) participation in equity (iv) provision of technical assistance. Only one Islamic bank i.e. Faisal Islamic bank of Egypt reported to use all the four methods; see Ausaf Ahmad, op. cit., p.69.

At present Islamic banks are mostly established either as a Joint Stock Company or a public limited company. Their financial structure reveals a complex and diversified pattern. The Islamic banks perform a number of banking functions. These functions range from opening of account for individuals and companies to undertaking direct investment and floating of subsidiary investment and trading companies. It is imperative for Islamic banks to conduct all their activities and perform all their functions in strict conformity with the Shari'ah. The business practice of Islamic banks includes: opening of current account, saving account, investment accounts and special investment account.

The structure of deposits has also undergone significant changes in Islamic banks. The relative significance of current account has declined and that of investment account has increased. The rate of growth of deposits showed that total deposits have increased at a faster rate in the initial period and at a slower rate in the later years. Similar trends could be observed about the growth of total assets. The structure of asset also exhibited changes over time. During the initial stages cash holding constituted a large portions of total assets. As bank matures, proportion of financial investment in total assets grows and that of cash holding declines.

One restriction is that the number of projects which can be financed by profit and loss sharing participation is limited; but supposing this number is large enough to employ all the funds of an Islamic bank, then other problems becomes obvious. One is that it would violate sound banking practices - and probably also the national banking laws and regulations - if short-term deposits were used for long-term financing. The higher the percentage of short-term deposits, the lower must be the amount which an Islamic bank can employ in long-term participation and investment financing.

Another limitation follows that if the bank has to employ the funds in such a way that an overall profit will result and which can be distributed to the capital owners and depositors every year, especially in the first year. Therefore, the bank cannot invest all long-term funds in newly established enterprises even if they promise high profits in the long-run; the short-term, new firms usually have not only no profits but close with losses in the first year. Thus the young Islamic banks have to channel some of their long-term deposits into investments which earn profits immediately, that is within the period during which the bank has to calculate and distribute profits.[20]

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20 See Arabia, (London) July 1984, p.47

Islamic banks perform all commercial, industrial, agricultural, transport, storage, mutual insurance activities, and so on. The capital in an Islamic bank is an essential guarantee to protect the deposits in the short-term and long-term. It is, therefore, necessary to impose strict conditions by stipulating a minimum of capital for Islamic banks, which is higher than the minimum for other banks. For the same reason, it is also necessary to be sticter in the ratio between capital and deposits in Islamic banks; for example; if the minimum for other banks is \$ 20 m capital, it should be \$ 30 m for an Islamic bank. If the ratio in other bank, between capital and deposit is 10 per cent, it should be 15 per cent in an Islamic bank. Most banking law required that the banks keep a part of the liquidity they are required to maintain in the form of deposits (with or without interest) treasury bonds or specified qualities, with the central banks. As Islamic banks are not operating on an interest basis it is necessary, while applying the restricted requirements of liquidity to allow the liquidity reserve required from them to be composed of elements in which Islamic banks are dealing, such as trade bills, shares and participating certificates of deposits, provided that it is negotiable according to special criteria.[21]

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21 Gammal Attia, "How the Central Banks can accommodate Islamic banking", Arabia (London), November 1984, p.51.

The basic ideas of banking laws for protections of deposits is the minimisation of risk. Islamic bank do not contest this principle although it is widely known that the basic principle of Islamic banks is the exposer of risk. This is not precisely the case and therefore needs some detail and precision. The rule has been established by many religious texts.

1. The yield (return) is commensurate with the risk undertaken.
2. The profit is justified on the basis of a likely loss.
3. The yield (return) on capital not exposed to risk is not permissible.

It is evident that any income from an interest-based transaction, where capital and yield are totally secured, is prohibited because of the lack of risk element on the part of the owner of the capital.[22]

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22 On the other hand, betting and gambling, whether they result in gain or losses, are prohibited operation because of the total risk involved. Between the two extremes of 100 per cent security and 100 per cent risk is located the area of allowed profit, carrying a portion of risk, ibid., p.52

It is upto the investor to choose the degree of risk, he opts to expose himself to, and naturally, the higher the risk, the higher the profit and, on the contrary, the lower risk involved the lower the profit. Consequently, the banking formula known as "security, liquidity and profitability" is also known in Islamic banking, though in different practical forms. Conventional banks take the principle of 100 per cent security in their transaction which can not be adopted by Islamic banks.

According to an Egyptian economists

> "The formula adopted by conventional banks to follow the 100 per cent security did not prevent them from getting into difficulties, the least of which is bankruptcy of some banks which happends from time to time. The real lesson we should learn from the dilemma of third world debt is that depending on the creditor - debtor relationship not being the real expression of the 100 per cent security principles, it could even lead to the total loss of both capital and interest. The solution would lie in a formula where the security on the face is less than 100 per cent but where the creditor participates in the management of the funds and shares the result of his investment, carrying the real security for both capital and yield."

Since the depositors in an Islamic banks share in its profit and loss, while the relationship of depositors to the conventional banks is one of debtor and creditor, it is recommended, while elaborating suitable system for the activities of Islamic banks, to give depositors a kind of supervisions, over the activities of Islamic banks, which could take the form of a depositor's, 'General Assembly', entitled to participate in the discussions of investment accounts and to elect the auditors. Attending such a depositor's General Assembly could be limited to those depositors who have a minimum of $ 1,00,000, for instance and whose period of deposit is one year minimum.[23]

Deposit Mobilization :

The Islamic banks so far have done an intensive research in devising non-usurious procedures to utilize their funds. Very little research has been done in devising the tools to attract deposits. This may be so because they have not yet faced the shortage of deposits. But if they do not pay attention to devise the non-usurious tools to compete with the interest-bearing tools of raising deposits, then these banks are likely to face problems in their growth particularly when they are working side by side with the modern banks. So far Islamic banks have the following types of deposits which differ from the deposits in other banks.

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23 *Ibid.*, p.52.

On saving accounts they are not obliged to offer any reward because the amount of the savings is guaranteed and the holders of these accounts are not liable for any losses that the bank incurs. This account, therefore, can attract only those customers who have money to save but do not want to take a risk and also are not keen to earn profits on their savings. Though, the investment accounts have the attraction of getting a higher rate of return than the current rate of interest this account will attract only those people who have the money to save, want to earn money and are willing to take a risk. For these two types of people, the Islamic banks have to compete with two institutions: (1) interest based banks (2) stock market. The third category of people, those who have money and want to earn profit on their savings without taking any risk, are not available to Islamic banks.

Ir is a general feeling that, as far as the tools to attract the depositors are concerned, very little research has been done in this area. This may be so because they have not yet faced the shortage of deposits. But as one writer points out that, 'if these banks do not pay attention to devise the non-usurious tools to compete with the interest-bearing tools of raising deposits, then these banks are likely to face problems in their growth. There has been a lot of theoretical discussion on the literature on Islamic banking as to how to save the depositors of investment accounts from the risk of the losses that the bank might incur. Islamic writers, in search of a viable alternative to interest-based banking, have suggested a number of schemes such as building reserves by the bank out of their good time earnings to compensate losses in bad time or launch deposits insurance with the backing of the Central bank and the cooperations of all commercial banks and their depositors.[24]

The slow growth in the deposits may not necessarily be reflecting the failure of Islamic banks to attract deposits but the fact remains that in a society where interest based banks are also allowed to exist, Islamic banks stand at a disadvantage. How they are going to successfully compete the interest-based bank is not clear from their current programme.

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24 M. Fahim Khan, "Islamic Banking as practised Now in the world", in Ziauddin Anmadled) Money and Banking in Islam, op. cit., p. 269; Fahim Khan points out that 'none of these scheme are so far operating and the depositors in the investment accounts stand liable to loss. None of the bank so far have undergone such a possibility. According to him 'an effort on a large scale is needed to devise non-usurious tools (going beyond conventional device) of banking that can raise the deposits for Islamic banks. The existing Islamic banks will have to do this research only in their own interest but also in the greater interest of the Islamic countries who are Islamising their societies.

It has been pointed out that Islamic banks in Muslim countries face certain special situation which is not shared by their counterparts in the capital-rich countries. The Islamic banks in poor countries will have to make an extra effort for resource mobilisation. Hence, it shall be necessary for them to undertake regional diversification so that Islamic banking does not remain concentrated only in urban centres. Large masses of population are concentrated in the rural areas in poor Muslim countries. In the event of regional diversification of Islamic banking, it might become possible to utilise the hidden and potential savings in the rural sector of these economies. Once the potential savings of the rural sectors are realized through Islamic banks, they could be invested in the project which would be socially productive. The choice of these bankable projects will have to be carefully made. It should be based upon the principle that local resources must be used for local development. Hence, priority must be given to small and medium size projects, covering agriculture, irrigation, handicrafts, small scale industry and agro-based industries in which local resources both financial and real, physical as well as human, could be utilized for potential use.[25]

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25 Ausaf Ahmad, op. cit., p.

Delays in Payment :

One problem which the Islamic bank faces is how to deal with cases of delay in payment. In the interest-based bank it is easier to handle this problem as interest gets accumulating and sometimes the rates are increased if the debt is not paid promptly. Payments for financing techniques that are used by Islamic banks also become due at a specified time. Since Islamic banks do not charge interest, delay in due payments may cause a number of problems for them. One way to solve this problem is to sell the "colateral" against which finance is provided by the Islamic bank. However, it may not solve the problem completely. Hence, Islamic banks have been exploring the ways and means to impose a fine for delay in payment. The main problem is that it should be done in such a way that it should not resemble interest payment charged by traditional commercial banks in similar circumstances. Hence, it is suggested that Islamic bank may impose some penalty on dafaulters for delay in payment in accordance with the stipulation of agreement in anyone of the following ways :

i. Claiming part of the profit which customers might have made during the period of default.

ii. claiming the profit which the banks could have made if the held up funds were returned promptly i.e., opportunity cost of these funds.

Exchange of Deposits :

With the expansion of its network in different countries the Islamic banks face another problem of exchange of deposit which need to be solved in conformity with the Shari'ah. The problem may be stated as follows: The Islamic bank A may have a surplus of US dollars and be in need of pound sterling. While Islamic Bank B in a different country may have a surplus of pound sterling but might be in need of US dollars. The following solution to this problem has been proposed:

i. "Agreement should be reached on the kind of two currencies for which exchange of deposits is to be made among the Islamic banks and value of each deposit is to be calculated at the prevailing exchange rate.

ii. Each party shall deposit with the other party the agreed amount as deposit which may be used and had to be returned on an agreed time.

iii. The same date shall be fixed for returning both amount so that each party shall return to the other what he would have taken in the form of an exchange of deposit.

iv. Agreement may be reached that each party enters the deposit from the other party in his investment account, it may also be agreed that both deposits be considered as a non-profit current account.

v. If both parties agree that each purchases from the others the currencies deposited with him by other party, that may be possible on the date of return at the rate of exchange prevailing on that date.

vi. No agreement may be reached that any party gain more benefit from the other except the right of use which is a mutual right for both parties.

There is a need to investigate the Islamic juridical, economic and operational aspects of this proposal. This problem is still being studied from different angles and no special solution has been adopted so far.[26]

'The structure of deposits has also undergone significant changes in Islamic banks. The relative significance of current

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26 These proposals have been quoted from Ausaf Ahmad's Development and Problems of Islamic Bank, op. cit., p.66.

accounts has declined and that of investment accounts has increased. The rate of growth of deposits showed that total deposits have increased at a faster rate in the initial period and at a slower rate in the later years. Similar trends could be observed about the growth of total assets. The structure of assets also exhibited changes over time. During the initial stages cash holding constituted a large portion of total assets. As the bank matures, proportion of financial investment in total assets grows and that of cash holdings declines.[27]

In Islamic banks, neither the principal deposit, nor a predetermined yield on it, are guaranteed, in theory, by the banks. In this way Islamic banks do not stand as an original party in the relationship between both depositors and users of funds, but performs, instead, the role of a proxy of depositors vis-a-vis the users of funds. This proxy has two kinds, first, a proxy including delegation from depositors to invest their deposits in any project, called "General Deposits, where Islamic banks invest with numerous users of funds and consider all these general deposits as one pool. Profits of investments are placed in this pool and then redistributed among depositors on the basis of a points product system (each amount multiplied by number of days) after deduction of management fees.

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27 Ibid., p.75.

Second, the proxy where the delegation from depositors is specified to investment of deposits in particular project after approval and acceptance of the risks involved. The profits of these projects are distributed among depositors after deduction of management fees of the bank. This is called in Islamic banking terminology 'specified deposits'. It is clear that in these two kinds of deposits and specially the second, the banks perform the functions known in the banking terminology as the "fiduciary function". It is also assumed that in both cases the depositor is aware of the risks to which this deposit is exposed. This principal of capital risk is an incentive for him to deposit his funds in this kinds of account and avoid depositing them in the pre-determined interest system. The principle of autonomous free-will of the parties where it is not contradictory to public order and public morale - is the suitable legal basis for allowing this kind of deposit.

The legal basis of the depositors' share in the bank's profit is the agreement of the banks share-holders (who are the only ones entitled to the bank's profit) to surrender a part of their profit to depositors. This legal analysis leads us to the problem of subjecting the yield, distributed among depositors, to taxes. It is known that the interest on deposits, paid by the conventional banks, is an expense, and is therefore, deducted from income before arriving at the net profit, which is subject to taxes. The net, after taxes, and reserves are to be distributed as divided to the shareholders.

In the case of Islamic banks, the accounting follows the same trend. The yield distributed to depositors (as opposed to dividends distributed to share-holder) is considered an expense on the profits of the bank, to be deducted before arriving at the net profits of the bank, subject to taxes. The treatment of the yield on deposits of Islamic banks on the same basis as the treatment of interest on deposits in conventional banks is normal as both are returns on money.[28]

Co-operation Among Islamic Banks :

There can be close cooperation between various Islamic banks because they share the same idealogy. Islamic banking in different countries and communities are trying to organize the banking business, which is backbone of modern economic and industrial system in consonance with the principle of Islamic Shari'ah, so these banks are operating at the same idealogical plane and share a common value system.

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28 See Gamal Attia "How the central bank can accommodate Islamic banking". Arabia, (London) November 1984, pp. 48-51.

At the operational level, the idealogical operation of Islamic banks may take several forums. For example, it may take the form of exchange information and ideas, several Islamic banks hold seminars, symposia conferences from time to time and publish information bulletin, magazines and books several Islamic banks have a Shari'ah board and economic research section attached to them. It is imperative for Islamic banks to pool their intellectual resources to find Islamically acceptable solution of the problems confronting Muslim Ummah in its social and economic transformation.

One expression of the cooperation of Islamic banks at the idealogical level is international Association of Islamic Banks set up in 1977. According to its statute the Association aims at "tightening the relations among Islamic banks, paving the way for cooperation among them coordinating their activities and ensuring their Islamic identity to achieve the Joint interest.

The association undertakes a number of activities and has participated in the establishment of Faisal Islamic Bank in Sudan, Egypt, Jordan, and Bahrain. It has undertaken various steps in the field of technical consultation among the Islamic banks. The purpose of this institute was to prepare necessary technical and professional manpower required for the growth of Islamic Banks.

Unfortunately, the Institute closed down after a couple of years of operation.

Islamic banks are in a position to undertake project financing, not only in the countries where they are located but in other Muslim countries as well. Since experience has shown that some Islamic commercial banks are reluctant to finance projects in countries where they are neither located nor represented, it would be in the best interest of Muslim countries themselves to have at least one Islamic bank in their country. This would not only pave the way for cooperation between Islamic banks and lead to growth of Islamic banks but could also be starting point for resource transfer from resource-rich countries to resource-poor countries. The mechanism of cooperation between Islamic banks can be Mudarabah and Musharakah and lending etc.depending upon the nature of project. Some of the Islamic banks are also holding equity capital in other Islamic banks also keep deposits with each other. Such practices would increase with the increase in the number of banks.

There are also people who hold the view that Islamic bank should have a full support from the Islamic Development Bank which is based in Jeddah. In this regard various efforts have been made.[29] For example, IDB proposed that there should be the involvement of Islamic banks in foreign trade operation of Islamic Development bank on the basis of risk - sharing. Also the involvement of Islamic banks in leasing operation of IDB where IDB bears all risk or shares it with Islamic banks. The other proposal includes :

1. extending line of learning facilities to Islamic banks which are at present extended to national development banks by the IDB;
2. co-financing of equity with Islamic banks;
3. IDB's participation in equity of Islamic banks.

However, to what extent these co-operational proposals are realized will depend not only on the IDB but also on the response of Islamic banks. However, it must be kept in mind that Islamic

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29 At the time of the annual conferences of the Islamic Development Bank, Board of Governors, representatives of various Islamic banks are invited as observers and a separate meeting of IDB and Islamic bank is held to discuss ways and means of mutual co-operation. The IDB also convenes joint meeting at other levels to exchange project information with the Islamic banks. Some of Islamic banks are involved in the investment deposit scheme of IDB. Which keeps some deposits with some of Islamic banks. The attempt to identify further areas of cooperation between Islamic banks and IDB is a continuous process. See Development and Problems of Islamic Banks, op.cit.

Development Bank is an international financial institution having special concern for economic and social development of member countries while Islamic banks are commercial banking institutions. Therefore, regional co-operation between these two types of institution is constrained by their different nature. The objective of Islamic Development Bank is to foster economic development and social progress of member countries and Muslim communities as well as jointly in accordance with the principle of the Shari'ah. In this regard, both Islamic banks and IDB carry the same idealogy. The project and activities preferred by the IDB may not be the same as those preferred by any Islamic bank. So, it has to be seen, in term of day-to-day working, that to what extent the Islamic banks can come forward to finance long-term projects. Thus, Islamic banks can play a useful role in social and economic transformation of Muslim society.[30]

The most common form of Islamic finance transaction is trade finance, where there has to be some element of risk. The Islamic institutions buy those materials from a seller and pay the seller and then sell those materials to the persons who really need.

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30 These views were expressed by Ausaf Ahmad, Ibid., p.72.

Another factor that puts the Islamic banks at a disadvantageous position in composition with interest-based bank is that the Islamic banks have to supervise and in some cases manage the operation of the projects that they are financing. This problem is serious in developing countries where the business enterprises, generally, do not maintain proper accounts or keep different sets of accounts for different purposes.

The extra management burden of the Islamic Banks also put it at a disadvantageous position vis-a-vis the interest-based bank. Islamic banks have to supervise and in some cases manage

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31 "Flexible, Liquid and benevolent; but confused", Arabia, (London) December 1984, p.44; Trrance Calson, an American Lawyer, deals primarily with Islamic financing and more generally with international business transactions such as acquisitions, mergers, joint ventures and licencing arrangements. Talking about the weakness and strength of Islamic banks he says : that the strength are first flexibility, second, great liquidity none of the Islamic Institutions I know of have difficulty in attracting deposits. It is not very likely that there is going to be a shortage of cash on that part of an Islamic institution. The third strength is that I think they do tend to look for projects that have a beneficient purpose and often will take more risk or perhaps take a lower rate of return if the project has a good purpose — if it is going to help people. Building hospital is one example.

the operation of the project that they are financing. It is considered that this problem is serious in developing countries where the business enterprises, generally, do not maintain proper account or keep different sets of accounts for different purposes. Fahim Khan, after surveying a number of banks writes that the presence of such mal-practices will raise the cost of Islamic banking. According to him unless such fool-proof devices are developed that do not entail these extra-cost of Islamic bankers, the growth of Islamic banking activities are likely to be constrained considerably. The Islamic banks have devised certain strict rules and regulation so that they select only sound parties but these procedures not only discriminate them infavourably against banks but also do not guarantee that their customers will be obliged to declare actual profit of their enterprise. None of the banks so far seems to have faced the problem perhaps, because either the Islamic banks have not expanded their business to the extent where they could feel this problem or because so far these banks have been dealing only in the real-estate and trade business where such management problem may not be significant".[32]

Apart from internal and local problems of Islamic banks, the participation of these institutions in international market

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32 M. Fahim Khan, op. cit., p. 273.

have raised many problems still to be resolved. Rodenry Wilson points out two major problems: First problem concerns the banking regulations in most western countries which stipulates detailed reserved requirements for all licensed banks and deposit takers. The view that the sole liquid asset must be cash or interest bearing treasury bills, does not confers with the Islamic principle: Islamic banks often hold commodities such as precious metals or even certificates of ownership of commodities as part of their liquid assets. The assets which the bank acquire for resale under the murabaha (profit-sharing) scheme are usually counted as part of their reserves, but western banking regulations do not recognise this.[33]

Another problem in the relationship between Islamic banks and conventional banks both in term of participation in clearing arrangements and dealings in the inter-bank markets. If an Islamic bank arranges currency exchange with Western banks, or even arranges acceptance of cheques drawn on other banks, it becomes involved with institutions which profits from interest transactions, and it may even end-up holding interest bearing assets itself.

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33 See Roodeny Wilson, "The Islamic Banking and Finance", The Middle East and North Africa, (Europa Publication Limited, 1988), pp. 160-164.

The experiment of Islamic bank, in so far as their results are concerned, have brought out something like this. At present, the Islamic banks have a narrow and rather limited sphere of operations. Their portfolios structure are not well diversified. In the beginning of experiment with Islamic banking, it was necessary for the banks to choose "less risky and quick return" type of investment projects for a variety of reasons. It would bring back the principal amount, generate profits and give access to resources for further expansion. It was instrumental in bringing confidence among the managers and succeeded in showing to the general public the over-all feasibility and viability of Islamic banking; consequently, Islamic banks concentrated investment in trades, real estate and constructions etc. - Although some of the Islamic banks have been undertaking equity participations in agriculture and industry, the number of such banks is very small. Now the initial viability being established, Islamic banks need to come out of safe pastures of "soft-investment" and invest in socially desirable long term investment projects.

The financing of long term projects by Islamic banks have certain pre-requisites not required by interest-based banks: The Islamic banks will have to identify projects, carry-out technical feasibility studies, estimate expected stream of profits and only then they shall be able to invest in a project. Moreover, they will have to develop a long term investment strategy. The interest-based banks usually are not concerned with macro-economic effects of their financing operations. The Islamic banks are expected to show more social responsibility in this regard by ensuring socially productive use of their resources.[34]

Muslim proponents believe that Islamic banks as compared to other interest based banks are operating at a relatively small scale. It is argued that the expansion of Islamic banks has to take place on two lines: first, Islamic banks need to be established in those muslim countries where there are no Islamic banks. The number of such muslim countries are 28. It is necessary to take actions for establishment of Islamic banks in these countries so that movement of Islamic banking does not remain localised one but becomes universal in Islamic world. Secondly, more and more Islamic banks need to be established in the countries

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34 A recent conference on Islamic banking held in London in April 1988 at London University's School of Oriental and African Studies (SOAS) focused on these problems. Professor Willian Ballantyne a barister specialising in Middle East law said : "perhaps what is required in today's climate is not just a restructuring of the Shari'ah to fit western economic concepts but some restructuring of those concepts in order to meet the Shari'ah. See "Banking Philosophies eye one another". The Middle East (London), p.30.

where they are already functioning. The establishment of new Islamic banks would strengthen the already existing banks. In that event, there would be more scope for inter-bank dealings among the Islamic banks. Slowly, one could expect the emergence of an Islamic banking system within each national economy which would complete with the interest-based commercial banking system and may really effect the direction in which investible resources are used. There is another dimension of expansion of Islamic banks. They must diversify their location regionally. At present, most of the Islamic banks are located in major urban centres. They should be ready to take Islamic banking to rural areas by opening more and more branches in the villages. The regional diversification of Islamic banks might help to develop saving and banking habits among the rural segment of population and promote resources mobilization for economic development.[35]

Islamic Bank vis-a-vis Central Bank :

In some countries, central banks prohibit the involvement of commercial banks in trading and investment activities. This is normally done to prevent industrial houses from setting up, commercial banks and then to use them to their advantages in other

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35 Development and Problems of Islamic Banks, op. cit., p.64.

industries. This is a big hindrance in the development of Islamic banks as these banks cannot function without indulging in trade and investment directly. Hence the central bank will have to grant Islamic banks some special concession in this regard.

The relationship between Islamic banks and central bank . was, and still is, rather tense. Islamic banks started in 1970s in Muslim countries which were dominated by conventional banking systems and governed by Western-style banking laws. Commercial banks in these countries, as well as central banks could not accept the idea of banking system not based on interest. Islamic banks were refused authorisation to operate. Responding to the pressure of public opinions however, the only way was to promulgate special laws exempting Islamic banks from the existing banking rules and even from the control of the central bank. Some Islamic banks were set-up under the patronage of governmental authorities, which were, by nature, far from the ordinary banking system.[36]

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36 "How the central banks can accommodate Islamic banking" Arabia (London) November 1984, p.48. Examples are the Ministry of Social Affairs for the Nasser Social Bank in Egypt (Religious Endowment) for the Faisal Islamic Bank of Egypt and Bahrain Islamic Bank. The Islamic banks prepared, as an alternative that the International Association of Islamic Banks such as the Islamic Development Bank of Jeddah. These proposals were not practical. The offer of, such an institution could be coordinations and cooperations and it would not cover any of the functions of central banks. Central banks pursued the subject, discussing it twice during the meeting of the central banks of Islamic countries, held under the auspices of the organisation of the Islamic conference. The direction of the discussion was steered towards promulgation of such laws, organising Islamic banking or at least, a change in banking laws to include a special section on Islamic banking activities — in both cases under the control of Central banks.

With the success of Islamic banks some rose within a few years to watch the rank of well-established conventional banks. Consequently, the central banks were forced to ask the legislative authorities to put this "unwelcome quest" under their control.

The central banks play a key role in supervising the commercial banking sectors. Therefore, a close central bank/ Islamic bank relationship is vital for the promotion of the Islamic banking and financial system. In most Islamic countries, the banking, licensing and regulatory laws are modelled on western systems designed to regulate riba banks. Their laws and regulations have been formulated to supervise and control the traditional banks whose objectives and functions are basically different from the Islamic banks. The principal differences arise from the fact that the Islamic banks are based upon participation principles while the conventional bank's deposits are protected through the mechanism of central bank under its existing regulations. The contractual relationship between an Islamic bank and its clients, and the types of asset held by it, makes it practically impossible to totally abide by the central bank's legal requirements. Therefore, exemption or amendments to the existing central banking regulations are called for which would enable the Islamic banks to fulfil the statutory requirements. Since the Islamic banks need extra help and assistance from the central banks in areas such as mobilisation of deposits, financial assistance and liquidity support, it is necessary for the central bank to make any financial provisions for rendering assistance to the Islamic banks.

The idea of central bank's control over the Islamic banks has been emphasised in order to protect their depositors as well as for the regulations of all their activities. The control will be in the form of internal regulations, control, mechanism, cooperation between Islamic bank in this respect and an exchange of experience among them - especially between the newly established ones and the older ones. Moreover, there should be neither total exemption of Islamic banks from control, nor their complete submission to the same rules governing other banks. Instead there should be different regulations suitable to the nature of Islamic banking, implemented by the central banks.[33]

If there are more than one Islamic banks in each country, it would be possible to persuade the central banks to adopt different policies towards Islamic banks. Central banks must be persuaded that they accept a lower proportion of total deposits in case of Islamic banks; and the Islamic banks may be allowed to borrow from the central banks against their deposits on an

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37 "How the Central banks can accommodate Islamic banking", Arabia (London), November 1984, p.48.

interest-free basis. Similarly, till the banking system in a Muslim country is Islamised completely, the Islamic banks and interest-based banks would continue to exist simultaneously. So long as the Islamic banking sector constitutes a rather small part of the total banking sector, the central bank's credit control tools are expected to be the same what they are at present. However, if the Islamic Banking sector grows and becomes a significant portion of banking sector in the national economy, central banks shall be compelled to take Islamic banks into account and develop new techniques of credit control to deal with them. Muslim economists also think that the central banks must make legal and financial provisions for Islamic banks, including the fostering of interest-free financial instruments, to enable them to function successfully with the existing international banking system. The role and functions of the central banks vis-a-vis the Islamic banks would have to be substantially different in areas of banking promotion, lender of last resort and credit control and regulations.

The central banks also need to accord at least equal treatment of Islamic banks so far as the fulfilment of the requirements, voting rights, licensing and establishment of new branches of Islamic banks. One of the major difficulties to the promotion of Islamic banks is the lack of interest-free financial instruments to enable them to meet the statutory liquidity requirement of the central banks, as well as to place excess liquidity in profitable ventures.[38]

The promotional aspect of the central bank's role in the Islamic banking development is extremely important and it will be an additional responsibility of the central banks in an Islamic society not to facilitate and assist the growth of new banks. Mutual sharing of experiences and know-how of central banking and Islamic banking operations, setting up of specialized departments in central banks would help Islamic banks.

The progress of the Islamic banking system will depend on the help and support that government and their central banking authorities are prepared to provide. In order to develop a market for interest free financial instruments, the central banks may explore various possibilities. These may include:

- allowing the Islamic banks to invest funds in instruments which may be issued by government corporations and agencies Islamically, on a divided basis, and to treat such investments for statutory reserve requirements.
- Opening Islamic investment accounts in the books of the central banks and paying profits to the Islamic banks for investment made by them in these accounts.

- issuing participation term certificates which would be yet another avenue for Islamic banks to invest on Shari'ah principles.
- purchasing from the Islamic bank some obligations such as murabah of customers of the Islamic bank and the profits accrued through such purchase can go to the central bank.
- participating in profit/loss sharing accounts of Islamic bank through investment in these accounts.[39]

The central banks also needs of the Islamic banks. Studies may be initiated for the creation of such markets where Islamic banks can place their surplus funds. In the areas of cash reserves and liquidity ratios, the regulatory measures by the

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39 The organisation of the Islamic Conference took official awareness of this important issue and set-up, under the aegis of Governors of Central Banks and Monetary Authorities of the Islamic countries, a high local committee to examine the whole range of relationships between the central banks and the Islamic banks. The committee met in Riyadh in March 1981 under the chairmanship of the Governor of the Saudian Monetary Agency (SAMA) and prepared an exhaustive report on the "promotion, Regulation and supervision of Islamic Banks", The report reaffirmed that the establishment of Islamic banks would reflect the sincere desire of the people of the Islamic world to apply the Islamic Shari'ah in different fields of life. See Arabia, London, Feb. 1986, p.62.

central bank vis-a-vis Islamic banks need special treatment. In the cases where the central bank pays interest on cash reserves, the ratios for Islamic banks need to be suitably reduced to compensate them.

The dialogue between the central banks and Islamic banks is an ongoing process. On behalf of the Islamic banking system, the International Association of Islamic Banks has already stepped into establish and coordinate contacts with the central banks and also to undertake further studies and research in Islamic banking fields with the help of eminent experts. Some countries have already amended their banking and other related laws and introduced new legislations where necessary, to enable the establishment and functioning of Islamic banks. Given the circumstances under which Islamic bank works, they are at a considerable disadvantage compared with conventional banks. The Islamic financial system needs to be supported nationally by well developed and sophisticated Islamic monetary regulations set by central banks.

Central banks, being the guardian of the banking communities in their respective countries, have a responsibility to exert efforts to promote Islamic banks. They have to set-up adequate guidelines for the regulations, supervisions and promotion of Islamic banks. Some of the areas where central banks can provide support may be summarised as follows:

Islamic banks cannot have access to money markets whether nationally or internationally, whereas conventional banks can easily resort to the central bank or other banks in case of a liquidity crisis. Therefore, the central bank is will have to make provisions, in its regulations to extend assistance to Islamic banks on basis of conforming to Islamic laws.

Since Islamic banks cannot deal with conventional financial instruments which are usually interest-bearing, central banks will have to look into ways and means of developing financial instruments which are interest-free. This will enable Islamic banks to make profitable use of funds they place with central bank to meet statutory liquidity requirements.

Solution to these problems requires a thorough understanding of the workings, technique and philosophy of Islamic banks by the monetary authorities. A special organ in the central bank has to be created to look after Islamic banks. This could provide a forum for exchange of views and experiences which could better place Islamic banks in their societies to play their role in full.

At the end we may conclude that the severe international economic recessions of the early 1980s posed a big test to the viability of the Islamic banks which had grown under the favourable economic conditions of the early decade. With the economic recessi the Islamic banks came under pressure from two sides. Firstly recession at home led to a squeeze on their source of finance. This was partially the case for the large multinational banks whose main source of finance, both share capital and the deposits, came from the surplus oil economies of the Middle East. The second source of pressure was the squeeze on the profit resulting from the surplus in the world trade and the decline in the return on real investment which comprised the main sphere of activity of Islamic banks. Despite such pressures the Islamic banks appear to have successfully passed through this difficult phase.

To pass through the recessions of the early 1980s many of the Islamic banks had to undertake major restructuring measures. if the 1970s was the decade of youthful growth and multiplication, the 1980s was one of maturity and consolidation for the Islamic banking movements.

On both front the Islamic banking movements have made major strides. Serious pitfalls have been overcome and valuable experiences accumulated. Though these past achievements are reassuring the future path of development of Islamic banking is by no means an easy one. An important factor which can help ease the future progress of Islamic banking is to build upon the accumulated experiences of the past.

At a time when the growth of the world economy is being shifted by the apparent inequalities of its financial system, the experiences of Islamic banking movement may even have valuable lesson for the debt-ridden third world economies.[40]

An international seminar on Islamic banking (held in Dacca March 1985) discussed the liquidity problems of existing Islamic banks and to facilitate: the establishment of Islamic monetary and capital market. The issues discussed were that Islamic banks possessing convertable surplus funds could channel their money to other Islamic banks with foreign exchange deficit for profitable and mutually beneficial investments. Furthermore, banks facing excess liquidity could initiate contacts with potential investors and provide them with necessary finance, rather than waiting to be opposed.[41]

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40 The latest results of Islamic financial institution confirm that in the era of economic difficulties due to falling oil revenues, especially in the Arab Gulf states, most of Islamic banks have shown remarkable resilience because it has ability to absorb the shocks of economic recession than Western banks. For a full report see; "Islamic banks-recessionproof", The Times of India (New Delhi) 15 January 1988, p.12.

41 See the report in detail, Inquiry (London) May 1985, p.24.

There is a general feeling that Islamic banks should develop new financial instruments, to help mobilize medium and long-term savings to bring them into line with medium and long-term investment. The bank could also promote small and medium sized projects to encourage mass involvement and to share in the economic development of Islamic countries. Banks should try to develop incentives and facilitates to attract business from clients. All these issues mentioned in this chapter, however, reflect that Islamic banks are not in total failures. But despite the obstacles in their operations and lack of proper instruments, they may perhaps, overcome some of the problems through experiments.

CHAPTER - V

MONETARY SYSTEM AND ISLAMIC BANKING

One of the complex issues faced by the Islamic bank is to work out the monetary system based on Islam. The questions discussed are : Is there any guidance from *shari'ah* regarding monetary and fiscal policies of Islam ? What is unique in Islamic monetary policy ? To what extent does it differ from the prevailing one, especially from the monetary policy followed in the capitalist world. How will the abolition of *riba* influence the monetary policy of a country ? Will the absence of the rate of interest as an instrument of monetary policy seriously handicap an Islamic economy ? Is a substitute for bank rate or other instruments of monetary policy feasible or desirable ? What alternative tools of monetary policy can be developed ? What will be the relationship between monetary and fiscal policies in an Islamic banking system ? These questions have been raised by many Muslim writers in various seminars and conferences. But their sufficient answers are not forthcoming. They generally come to the vague conclusions that what is required is 'a fundamental reform of the entire economic system including its money and banking framework. The reform of the later would include the abolition of *riba* and the reform of banks to minimise their financial power and their role in skewed income distribution. It would also include a change in the strategy and instruments of monetary policy aimed at regulating the expansion of over all credit in accordance with the non-inflationary needs of the economy as well as the value oriented allocation of credit to attain the desired socio-economic goals of Islam.[1]

As regards the nature of monetary policy,it is argued that in an Islamic economy its objectives and tools must be different because of the differences in the goals and nature of two systems and because of the prohibition of interest in Islam. Moreover, the monetary policy in an Islamic economy should not only be in conformity with the ethos of Islam but should also help realise the socio-economic goals that Islam emphasises. The proponents of Islamic banking mention the following are the chief objectives of the Islamic monetary policy:

1. Economic well-being with full employment and optimum rate of economic growth,

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1 See An outline of Research Proposal in Fiscal and Monetary Policy of Islam' (Jeddah: International Centre for Research in Islamic Economics, 1982).

2. Socio-economic justice and equitable distribution of income and wealth; and

3. Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of differed payments and a stable store of value.[2]

According to them the capitalistic or socialistic economy cannot be in conformity with Islam, although there may appear some apparent similarities between these systems. In a capitalist economy the monetary policy affects the real sector only through the rate of interest. In an Islamic economy, it is claimed, the rate of interest will be replaced by the rate of profits. The rate of profits, however, depend on the business conditions. The investment decisions in an Islamic economy would not depend on the rate of interest but only on the expectations about business prospects. The proposition that an Islamic economy is inherently stable appears to be some what far fetched. The main issue, however, is not whether an Islamic economy is inherently stable but whether it is potentially stable in the sense of having access to various stabilisation policy instruments. But as the critics feel the only orthodox policy

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2 M. Umar Chapra, "Monetary Policy in an Islamic Economy", in Money and Banking in Islam (ed.) by Ziauddin Ahmad, (Islamabad: Institute of Policy Studies, 1983), p.27.

instrument still available to the central bank in an Islamic economy will be 'moral suasion' and power to change the deposit ratios for regulating the lending activities of the commercial banks. They believe that these policy instruments will not provide a really effective handle to the central bank for control of the money supply, particularly when excess liquidity exists in the banking system. In this way, as they point out, an Islamic central bank would not have too many 'degree of freedom' in exercising a decisive control on money supply through indirect means for the lack of sufficient number of policy instrument.[3]

It is argued that the absence of the interest-rate instrument will not cripple the monetary policy in an Islamic economy, since interest rates as an instrument of monetary policy is not all that powerful even in a capitalist set up. However, the scope for monetary policy in an Islamic economy is somewhat limited, not because of the non-availability of interest rate instruments, but 'because of the neutralising changes in the velocity of money circulation'.[4]

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3 S.N.H. Naqvi, Ethics and Economics, (The Islamic Foundation, U.K., 1981), p.134.

4 Muhammad Ariff, ed. Monetary and Fiscal Economics of Islam (Jeddah: ICRIE, King Abdul Aziz University 1982), p.13.

What is noticeable is that how in the absence of speculative free stock exchange and 'market rigidities', the Islamic economy works. How inflationary trend would be checked where profit-sharing will play an important role. Again, the danger of monopoly and oligopoly cannot be ruled out since privatisation will go hand to hand in an Islamic economy which will run on the market forces of supply and demand.

Monetary policy may be defined as any deliberate action undertaken by the monetary authority to alter the quantity availability and cost (i.e. interest rate) of money. It then becomes clear that interest rate is only a part of the story. Although interest rate changes apparently and influences the demand for and supply of money. But it is also conceivable that changes in the quantity and availability of money even without the interest rate. Be that as it may, monetary policy based on interest rate manipulation suffer serious shortcomings, which have severe implications for the efficiency of monetary policy.

Islamic economists, while criticising the Western concept of monetary policy, feel that monetary policy in modern times seems to have regained the respectability it had lost under the keynesian assault. Friedman and his disciples, in asserting the potency of monetary policy, have emphasized that the crucial variable is the stock of money, and not the rate of interest. This message of new monetarism has far-reaching implications for the role of monetary policy in an Islamic economy where interest rate is totally prohibited.

But how the mechanism of the Islamic monetary system will work ? According to its proponent:

> "The volume of money can be varied for example, through the sale/purchase of government securities to/from financial institutions and through adjustments in the statutory ratio of such securities in the "advance" portfolios. In inflationary times, a rise in this ratio will siphan off a large proportion of the excess money which has been deposited with financial institutions. In addition, the central Bank may give directions to financial institutions regarding the volume and composition of their financial commitments. All such restrictive measures may effectively curtail the availability of funds for investments. But in times of depression, 'funds unlocked through the government purchase of its bonds may not necessarily stimulate investment activities if permissitic business expectation prevails'.[5]

It is further argued that the financial institutions, in an Islamic economy, being essentially profit-sharing and equity-

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5 Mohammad Ariff, "Monetary Policy in an Interest-free economy - nature and scope", in Ariff ed. Monetary and Fiscal Economics of Islam (Jeddah: International Centre for Research in Islamic Economics, 1982), p.299.

seeking institutions can play an active role in contrast with the passive role of conventional financial institutions outside the Islamic set-up. The Islamic financial institutions can therefore lead the business community and influence the business outlook by injecting confidence and stimulating investments in time of economic recessions.[6]

The argument that the establishment of Islamic bank will provide a stimulus to aggregate saving, has been doubted by a number of writers. In this connection Timur Kuran points out that in countries where Islamic banks are in operation the stock market performs in inefficiently, and, because from the standpoint of individual saver and investor, mudarbah accounts serve the same function as stocks. The bulk of the individuals who have switched to Islamic banks are probably relatively less risk-averse savers who would, if the economy were more developed, be holding stocks. If this conjecture is correct, one can infer that the establishment of Islamic banks has stimulated savings by introducing a new financial service. This does not mean, however, that savings could be increased further by abolishing the traditional banking system, for, the highly risk averse

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6 Ibid., p. 299

customers of traditional banks may not feel comfortable with mudaraba.[7] In this regard, as we have earlier mentioned theoretical analysis has not provided a clear-cut testable hypothesis, and it becomes an empirical question whether saving will increase or decrease in an Islamic i.o. system. Since consumption is always placed on a relatively low-key basis in an Islamic society, the marginal propensity to consume is somewhat low, and a low consumption propensity implies a rather weak multiplies mechanism which does not permit economic disturbances to be magnified. This considerably reduces the chances of economic fluctuations.[8]

As mentioned above,the usual objectives of monetary policy are stability, balance of payments, growth of the economy and distributive justice.

As far the policy issues are concerned, one may feel that too much emphasis on distributive justice in the Islamic monetary

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7 Timur Kuran, 'The Economic System in Contemporary Islamic Thought : Interpretation and Assessment", International Journal of Middle Eastern Studies, (U.S.A.), Vol. 18, No.2, May 1986, pp. 135-164.

8 See Waqar Masood Khan's, Towards an Islamic Economic System, (Leicester: The Islamic Foundation, 1985).

policy may adversely affect its over all efficiency and effectiveness in obtaining other goals. In a seminar held in Islamabad in 1982 Muslim economists gave attention to monetary policy instruments that could be used in an Islamic economy to achieve the stated policy objectives. The general feeling was that abolition of interest, and non-availability of bank rate weapon to the central bank would not constitute any serious handicap to monetary management in an Islamic economy. It was pointed out that control over the volume of money supply is a crucial factor in monetary management. Adequate control could be exercised on money supply in an Islamic economy by regulating high powered money, defined as currency in circulation and reserve assets of banks. Besides, use could be made of various in cash reserve ratio, liquidity ratio and credit ceiling to bring about desired changes in money supply. Apart from controlling money supply, monetary policy is also capable of being used to influence the allocation of resources. In the interest-based system, variations in interest-rates and policy-induced differentials in interest rates perform an important allocative function. This role could be performed by changes in profit-sharing ratios in an Islamic system.[9]

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9 See the report on Money and Banking in Islam, op.cit., p.7.

How will the proposed monetary policy overcome its problems ? Doubts have been raised regarding the efficiency of a central bank in Islamic economy. We have mentioned that lack of financial instruments and the absence of various tools like open market operation, and deposit ratios are the main obstacles in the functioning of central bank proposed by Islamic economists. There is every possibility that monetary policy will be weakened as there is no clear cut answer to stop the inflation and unemployment. In fact, the defects of capitalist monetary system cannot be seen in the context of interest rates, only, or that mudarbah system is the ultimate answer to these problems. Many Islamic economists are still not satisfied with the profit and loss sharing. After all, an Islamic economy cannot be created in vacume. All the social behaviours and norms of human being cannot be dismissed. So far as the Islamic economic system is concerned, there are many writers who question the soundness of the arguments regarding the effectiveness of the Islamic norms. First of all, the implications of these norms are unclear in most of the context where they are expected to operate. 'A pious Muslim eager to follow them may be confused as to what wage is just and what profit rate is normal. Likewise, he may be unclear about the meaning of "moderation" in consumption and of the practical implication of the injunction against harm to others through productive activities". This vaguners, as critics argue would threaten the legitimacy of the Islamic economic system. One writer, for example, finds that the fundamental features of the proposed Islamic economic system, raises serious doubts about the claim that this framework provides a functional alternative to existing system. He says:

> • "The suggested behavioural norms are not only riddled with ambiguity, but also unlikely to enjoy widespread adherence in a large society. In practice, many of them would have to be treated as state-enforced laws. There is no way of ensuring, moreover, that state officials would behave in an Islamically "correct" manner. These criticisms are borne out by the fact that throughout most of the past fourteen centuries, members and officials of Muslim communities have had a tenuous link with Islam's behavioural norms, even when they have more or less agreed as to what these norms means".10

<u>Credit Control and Credit Operation of Islamic Banks:</u>

Credit control in the contemporary financial world is of great significance. It affects the consumers, business and governments, Consumers borrow to buy the goods and services they want now. Business borrows to finance investment projects. Likewise, the government borrows for meet its various needs. It

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10 Timur, Kuran, op. cit., p. 134.

borrows for defence spending, socio-economic programmes, payment of the interest old debt. The government borrows funds through the central bank, and then lends to small business, farmers, low-income groups and others. Keeping this in mind economists have given much attentions to the problem of credit regulator. In capitalist economies money market occupies a central place. Change in credit policy and trends has its impact on the Gross National Product. When credit is plentiful, banks are more generous in making loans for the building of inventories, construction of new factories and residential housing. Thus a rapid growth in money and credit accompanies booms, and a reduction in money and credit is often followed by recession or worse.[11]

A bank, having received some cash from customers who have brought funds to the banks is therefore in a position to make loans or investments. A bank, say bank A, starting out with deposits in currency and coins of Rs.100,000, might feel safe to lend Rs. 80,000. In a check-using community, the bank would make its loan by giving the borrower the right to draw checks against it. In fact the procedure of credit creation comes through the

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11 James S. Duesenberry, Money and Credit : Impact and Control, 3rd ed. (New Delhi: Prentice, Hall of India, Private Limited, 1979).

whole set of banks. These banks would create an amount of money in the form of deposits equal to several times the amount of the original deposits. Commercial bank deposits constitute a significant part of money supply. These deposits may be divided into two parts; firstly, primary deposits' which provide the banking system with the base money (cash in values plus deposits with the central bank) and drivative deposits' which in a proportional reserve system represent money created by commercial banks in the process of credit extensions and constitute a major source of monetary expansion in economies with well-developed banking habits. Since deriative deposits lead to an increase in money supply in the same manner as currency used by the government deficits, it has the potential of being inflationary in the absence of offsetting growth in output.[12]

The relation between credit created by the commercial banks and resulting output is the major problem that muslim economists argue in the case of inflation. Contrary to conventional systems, they say that Islamic concept of profit-sharing system is more stable. It is argued that :

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12 Ibid., Ch.3

> "Bank's mudaraba advances could still be a multiple of their saving deposits, but their return accrue as a percentage of profit actually realised when these advances results in creation of additional social wealth. These returns are then shared by the bank with the depositors according to an agreed percentage. Accruals of profits on deposits in this case devolves on exposer of risks involved in productive enterprise. The magnitude of these profits is determined by the conditions of market and the two ratios of profit-sharing which are the subject to the forces of demand and supply. The power of real savings to acquire additional resources with the mere passage of time is completely destroyed. Instead they have the possibility of acquiring additional resources to the extent that their utilisation in productive enterprise actually results in the creation of additional wealth".13

The present system as it is pointed out prompts the banks to patronise speculators, other financial intermediaries and the government who are ideal short-term borrower. The ultimate investors figure in their portfolios only marginally and often indirectly. 'The unusually lengthy chain of intermediaries between the ultimate investor is largely a product of case with which credit instruments can be created and handled, thanks to interest. They bear very little relations to the structure of production. To justify this proliferation of financial intermediaries and credit instruments with reference to the variety

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14 M.N. Siddiqi, Issues in Islamic Banking, (Leicester: The Islamic-Foundation, 1983), pp. 55-57.

of tasts, regarding liquidity, risk, size of holding and time period involved presumes a sanctity for these tastes which is highly doubtful. To a very great extent they are the product of high powered propaganda and psychological manipulation'.[14]

The arguments against credit creation by Muslim writers, have centred around the issue of inflationary trends. They say that inflation is partly due to credit expansion by commercial banks. According to the current literature to the only effective means of curbing inflationary trends, is that commercial bank should not be empowered to create additional credit and this job would be done by the Central Bank. This issue begs numerous questions which Islamic writers have discussed in various conferences and seminars.

The question of credit control in Islamic financial system is a major issue which is still at discussion level. How the central bank will control the money supply since there is no element of rate of interest in its functioning. This question is much related to the goal of price stability and rapid real growth. As in conventional system, we see that central bank's monetary policy work through the control of monetary expansion. The mechanic of the system is that when the central Bank wants to

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14 Ibid., p. 57.

control the money supply, it cut down on the reserves available to the bank. The Central Bank change this reserve through the "open-market-operation". In this way the reduction in the bank reserves forces a multiple contraction in total bank money. The contraction in the money supply tends at first to make money 'tight' - that is more expensive and less available. The reduced quantity of money, in other words, raise the cost of money (i.e. interest rate) and reduce the amount of credit available to people. With interest rates higher, and with credit hard to get results in the reduction of wealth of the people and companies. There are also effects in private and public spending, which reduces the investment. A reduced supply of money tend to reduce aggregate demand, income, output, jobs and inflation.[15] This long process of central bank in conventional system makes an impact on money and credit control. As for the Islamic financial system is concerned, we find that the role of central bank, is rather weak, because it would be unable to alter the reserve requirements. In this way, the stabilization targets would have to be realized through the control of the monetary base rather than credit. A recent study, regarding this issue, shows that the monetary authorities operating in an Islamic frame-work continue to have the power to regulate banking and financial operation in the economy. To achieve its policy

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15 See Paul A. Samuelson, Economics, 12th ed. (Mc Graw-Hill Book Co. 1985), Ch.15.

objective; the central bank has the control over the supply of 'high powered' money (that is currency plus deposit liabilities of the central bank to commercial banks), the reserve ratios on the different types of liabilities, and the maximum amount of assets that bank can allocate to their profit-sharing activities. A further control is available to the central bank through its purchase of equity shares of banks and other financial intermediaries. Though performance of its regulatory, supervisory and commercial functions, as well as its lender of last resort role, the central bank can continue to make influence on the financial system. Moreover, opportunities may exist to direct investing in the real sector on a profit-sharing basis. The ability to buy and sell securities representing real asset in the financial market, that is, open market operations, would still be permitted as long as these securities do not have par value features and a non-zero coupon rate. The suggestion has been made that central bank could regulate profit-sharing ratio between the banks and borrowers on the one hand and the banks and depositors on the other. Variations in these ratios would alter the rates of return and could have the same impact as changes in interest rates on the other all and sectoral flows of financial resources.[16]

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16 Mohsin S. Khan and Abbas Mirakhor, "The Frame Work and practice of Islamic Banking", Finance and Development, September 1986, pp. 32-36.

We may not simply over-look the western financial system as being 'inflationary' or that credit creation of commercial bank can not be controlled. The contemporary banking system which is governed by the Central Banks of the governments have their own tools to control the credit supply, and hence check the money expansion into the economy. Hansen tells us that under the fractional reserve system if the banks keep a reserve ratio of one-tenth (that is, if they keep their cash reserve at about one-tenth of their total deposit), it follows that for every additional cash dollar obtained by the bank they create ten dollars of bank money or deposit. As the banking business is concerned, the modern banks do not keep 100 per cent reserve for their deposit, on the contrary, banks are required, by law to keep a small fractional reserve for each $ 1 of deposits. These deposits can be held in cash on hand or in non-interest bearing deposit at the central bank. If bank kept 100 per cent cash reserve against all deposits, there would be no multiple creation of money. There would be only a I - to I exchange of one kind of money for another kind of money.[17]

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17 Alvin H. Hansen, Monetary Theory and Fiscal Policy, (Mc. Graw-Hill Book Company, Inc., 1949). Ch.2.

Islamic writers favour imposition of a 100 per cent reserve requirements on commercial banks. It is justified on three grounds : Firstly, they blame that fractional reserve[18] causes the monetary system to suffer from an "inherent unstability" because any switch over from "high powered money to "deposit money" and vice-verca changes the supply of money. But with 100 per cent reserve, as they claim, such a switch will change only the composition of money, leaving its total supply constant. Secondly, changes in money supply arising from deposit creation or resulting from substituting deposit and cash make it more costly to maintain the existing stock of real balance. Thirdly, money creation is a social prerogative and hence the benefit of the process of money creation should accure to the whole society which can best be achieved through 100 per cent reserve system.[19]

One writer outlines a model with 100 per cent reserve system in which the liquidity and financial requirements of the

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18 Fractional reserves banking means modern system of banking where only a fraction of deposits are held as reserves, the rest are used for loans and investments. Their vital function is to enable the central bank to control the amount checking deposits or bank money- that banks can create. By imposing high fixed legal reserve requirements, the central bank can limit the growth of bank money to its desired target.

19 See Money and Banking in Islam, op. cit., p.6.

private business sector will be met by the Central bank's opening deposit and investment account in commercial banks and other financial institutions which in turn will invest these deposits in the real sector and share the profit with the central bank. Variations in the central bank's deposit accounts with the commercial banks will have the effect of bringing about the desired changes in money supply.[20] This concept however, leads to the realization that commercial bank will be reduced to safe-keeping institution like the goldsmith's establishment of the bank which was the basis of the evolution of modern banking system.[21] This also means that commercial bank cannot even invest the funds deposited with them. However, Muslim writer's argument about central bank's role makes one to think that central bank's effectiveness will diminish especially in the matter of monetary policy.

Islamic economists in this way, think that with the 100 per cent reserve requirement there would not be any major change in the vital role of the central bank. It's regulatory power over the supply of money by denying or granting loan to the

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20 Money and Banking in Islam, op. cit., p.7.

21 Commercial banking is said to have began with the goldsmith, who developed the practice of storing people's golds and valuables for safe-keeping. At first, such establishments were simply like warehouses. Depositors left gold for safe-keeping, were given a receipt, later presented the receipt, paid a small fee for the safe-keeping and got back their gold.

commercial bank is recognized. They, however, accept that in an Islamic system, central bank's loan to commercial banks are supposed to be limited, as financial assets in general are likely to be risk bearing and central bank's involvement in risk financing may reduce its status as the regulatory authority. However, loans may be sanctioned against reserves with the central bank. What they find injustice in the present system is the charging interest by commercial banks while their money is laying idle with the central bank in the form of reserve.

In this regard, another question related to this is asked as how the commercial banks in the Islamic system would utilize their current account balances. If the balance is utilized for short-term profit-bearing advances, then the depositors will have to bear risk which they may not be willing to do. If 100 per cent cash is maintained, the cost of transactions on current account may be too high for smooth commercial functioning.[22] For this purpose it is proposed that a service charge on such transaction will compensate the cost of mainting these transaction. The concept of service charge, however, is highly controversial. A good numbers of writers find it as similar to interest.

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22 Ibid., p. 64

According to an author's view, the 'claims that this is different from charging interest since it is not tied to the length of time within a month or to the size of loan. This is a misleading argument. First, though the rate is not tied to the length of time within a month, its upper limited is a month, thus there is a time dimension. It is analogous to an annual rate which is not tied to the time period within a year. Second, there is an upper bound on the size of such loans since these loans ...., can not be more than the average past liquidity position of a borrower with the bank. Therefore, we safely conclude that this charge is similar to interest paid on a bank loan'.[23]

Inflation and Islamic Economy :

A survey of Muslim literature on money and banking indicates that question of inflation has occupied the minds of many proponents of Islam banking ... as to what extent an Islamic economy could bear the evils of recession, depression and inflation ? Is a long-run inflationary trend possible or desirable in an Islamic economy?

Even if it is possible to control inflation in an Islamic economy, will it be possible to overcome a recession? What if

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23 Waqar Masood Khan, Towards an Interest-free Islamic Economic System', op. cit., p.37

prospects are dim and the commercial banks and the associated private sectors are not willing to expand their mudarbah investment? However, this hypothesis may be doubted on the ground that monetary policy alone cannot solve these problems unless other government policies also work in the same direction. It is common experiences of the industrial countries that effects of monetary policy are often negated by unduly 'expansionary fiscal policy. It is said that multiple credit creation by banks also leads to inflation. It is, however, argued that some kind of indexation would be necessary at least during transitory period to protect capital from erosion[1]. The suggestion of indexation in the time of inflation cannot be ruled out, because, in practice, the money value of a loan would be increased in line with the rising inflation so that the borrower would have to repay the loan in real term. In the sbsence of indexation, rapid inflation, by eroding the real value of loans, shifts resources from lenders to the borrowers and therefore disrupts the credit mechanism and capital market. Some economists, however, consider that indexation is not a cure for inflation. Because if it was so, the entire economies of western would have adopted this method. In this way, they would have ignored inflation and concentrated on reducing unemployment. This sounds like a good idea. But on closer look it turns out that more you protect the economy from inflation by indexation, the more unstable inflation becomes.[26]

A cautious summary of this discussion would be that an Islamic economy canot overcome the misery of inflation simply by adopting the indexation method. Today's inflations come in through various ways. Economists today think that there is natural rate of unemployment which bring inflation into the economy. This phenomenon is bound to happen even in an Islamic economy.

Demand for Money in Islamic Economy:

It is claimed that in the Islamic economic system the concept of money is somewhat different from other prevailing system. Though Muslim writers acknowledge that basic concept of money as explained in the economic theories will not be very different from the prevailing one. Questions have been raised as what should be the characteristics of money in an Islamic economy.

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26 Paul A. Samuelson, Economics Twelfth Edition (Mc Graw-Hill Book Company 1986); The author illustrates that indexation may be temporary device to check inflation. But assuming that whole economy is to be indexed, then problem will arise. For example, suppose that wages, rents, interest rates and prices are all 100 per cent indexed to the consumer price index (CPI). say a bad harvest drives food prices up enough to increase the CPI by 10 per cent. The shock will rage through the economy like an epidemic. Everything indexed to the CPI goes up 10 per cent. But since all costs are indexed, the next month CPI goes up almost 10 per cent again. And the third month, price rise almost 10 per cent again. And in this way price would be up many times (p. 255).

Do the various present day forms of money fulfil these characteristics? Is there any room or scope for a rising price level? Would such a trend be in harmony with a riba-free Islamic economy? Keeping in view the main objective of an Islamic economy, is it necessary to have full-bodied or fully representative money in an Islamic economy? What is the scope for 'fiat money' ? How does 'fiat money' with a declining real value fit into a riba-free Islamic economy? Would the central bank in an Islamic economy have the privilege to print money without the lacking of real resources ? If this privilege is to be recognised, can some guiding principles be provided in the light of shari'ah to prevent government from exploiting this privilege and to save the economy from the effects of inflation resulting from rapidly expanding fiat money. What is the scope for deposit money in an Islamic economy, and in the light of shari'ah is it possible to say specifically whether any individual or institution has the right to lend money which he or it does not have. Is it possible for an Islamic state to make its money immune from the monetary, fiscal and foreign exchange policies of other countries.[27]

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27 See Ariff, op. cit., p. 381

All the above issues make a complex situation for Muslim writers to reach a definite conclusion as to what would be the real position of an Islamic economy. Since there is not any real Islamic economy. It is difficult to say anything with certainty on the above issues. Some writers try to point out that in an Islamic economy' the demand for money will arise basically from the transaction and precautionary needs which are determined largely by the level of money income and its distribution. The abolition of interest and the levy of zakah at the rate of two and half per cent will tend to minimise the speculative demand for money.

Muslim writers have presented their arguments in the context of capitalist economy where demand for money have always engaged the attention of economists. According to modern economic concept the demand for money arises from the need for a medium of exchange, that is, from a transaction demand. People hold currency to buy goods and pay for other services. As the incomes rise, the value of the goods goes up and therefore people need more money for transactions, and in this way, the demand for money rises. The demand for money differs from that of other commodities. It is so because money is valued for its use as indirectly and not for its direct utility. At the same time money holdings are limited because money has an opportunity cost.

Economists believe that the demand for money will be sensitive to interest rates. By this, they mean that with higher interest rates the demand for money will be low. The classical economic concept of three motives, i.e. transactions motives, precautionary motives and even speculative motives are considered to be appreciable even in an Islamic economy. Though explained by Keynes,[28] these motives in the capitalist system are foundation of the demand for money. However, among these there motives, the speculative demand for money has raised some questions. It is felt that there is room for speculative motives in Islam. This is so because speculation often entails stockpiling and profiteering activities which have adverse economic implications for the community at large.[29]

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28 John Maynard Keynes,(1883-1946) General Theory of Employment, Interest, and Money, (New York: Harcourt, Brace, & World, 1936). Keynes called the need to hold money as a means of payment the transactions motives for holding money. In addition to holding money to make normal day-to-day purchases, people may also hold some extra money to deal with unexpected circumstances.Keynes called this the precautionary motive for holding money. In addition, however, Keynes distinguished a third motives for holding money called as speculative motives. Because people may prefer to hold much of their wealth in the form of money, hoping to exchange the money for bonds after interest rates rise and the price of bonds falls. In this way, Keynes thought that the demand for money depends both on the level of nominal income and on nominal interest rates. As nominal income arises, other things being equal, the demand for money will increase because of the transactions and precautionary motives. But given the level of nominal national income, the speculative motive will tend to make the demand for money increase as nominal interest rates decrease and to make it decrease as nominal interest rates increase. For a full treatment on the subject see; Stephen M. Goldfeld, Lester V. Chandler, The Economies of Money and Banking, 9th ed. (New York: Harper & Row, Publishers, 1986) part 4.

29 Mohammad Ariff, ed. Monetary and Fiscal Economics of Islam, op. cit., p. 297.

A closer look at demand for money concept of interest-free system reveals that it is quite different from what is now prevailing in existing financial world. As we have seen, creation of money in an interest-free system will be investment oriented, not based on lending. Here arises the questions that in the absence of interest rates what will influence the borrowing and lending. This is because interest rate influences the amount of money people want to hold and thereby the amount theylend or borrow.[30]

Islamic monetary policy suggest that 'interest-bearing asset, in an Islamic economy, would not be available; leaving the holder of liquid funds the option of either holding them in the form of cash with no return or investing their profit-earning assets to get at least some return. Short-term as well as long-term investment opportunities with varying degree of risk will presumably be available to all investors whether they are high or low risk takers. This is perhaps the most challenging issue, so far the available studies and related conclusions force one to ask that while implementing an Islamic financial system how the risky return-bearing instrument can be devised so that sufficient degree of liquidity, security and profitability can be attained.

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30 Differences in interest rates on different kinds of securities, influence how borrowers obtain their funds and lenders invest their funds. Thus changes in specific interest rates draw money from market where funds are plentiful to markets where they are scarce. See the whole process in extensive analysis by David E-Laidler, The Demand for Money: Theories and Evidence (Bombay: Allied publishers, 1972) part 2.

CHAPTER - VI

EXPERIMENTS IN ISLAMIC BANKING - EGYPT

Development of banking system in West Asian countries was the result of their trade relations with the western countries. Arab traders imported durable goods from the West and international companies invested in oil exploration and light manufacturing in the Arab region. This of course, required flow of payment in both ways which, in turn, led to the establishment of foreign banks in the Arab world. Initially, British and French banks were dominant and spread all over the Arab region, particularly after World War II. American banks came in later in the 1960s. At that time, there were no Arab banks in the western countries. Trade payments, expatriate remittances and corporate profits were therefore channalised in and out of the Arab world through foreign banks or through Arab banks with international correspondents. The Arab merchants stepped into international banking in the 1970s mainly because this decade witnessed a substantial expansion of Arab financial resources, particularly in Arab oil exporting countries of the Gulf Cooperation Council.

The availability of funds and absence of restrictions are two important considerations that have facilitated the entry of Arab banking into international arena. Arab participation took various forms, starting in the late 1960s, Arab banks formed joint ventures with large European banks. Example of these include the French Arab Bank (FRAB) and the Union of Arab-French Banks. These arrangements reflected the prominance at the time, of Beirut based Arab banks and their strong ties with France. There was also a move towards London, where other joint ventures were formed, notably the Saudi International Bank.

By 1975, different arrangements evaluated in response to new opportunities. For the first time, the Arabs established their own banking consortia to cover new markets. For example, a large pan-Arab consortium established the Gulf International Bank in Bahrain. All the GCC governments and Iraq participated in the formation of this bank five years latter. The Arab banking corporation followed, and by then, Bahrain had become an important offshore market serving the whole region.[1]

Apart from its, this region is also known as a centre of Islamic banking. Some of the oldest and largest Islamic banks are

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1 Jean - Francois Seznes, The Financial Markets of the Arabian Gulf, (Beckenham : Croom Helm Ltd. 1987), Ch.3.

located in the region, operating in an environment of Islamic ideas on banking and commercial activities. These Islamic banks have their specific features that differ from other banks. In particular, Islamic banks are by definition investors. This means that they cannot deposit their funds in other banking communities, like other commercial banks. This is a challenge that the Islamic banks face, especially when such traditional banks are working in a different atmosphere, working according to different rules than those that should govern Islamic banks.

In this chapter we will see the functions and performance of Islamic banks being experimented in Egypt and Saudi Arabia. Although the full scale operations of Islamic banking persist in Iran and Pakistan where experiments have attracted the attention of bankers and economists, we have selected the former two countries mainly due to the fact that the Islamic bank originated in Egypt and that Saudi Arabia has also played a key role in the development of Islamic banking system in Muslim countries.

Islamic Banking in Egypt :

In Egypt, Islamic banks emerged in response to a huge popular demand. As soon as the Islamic banks were set-up they were attracted by customers. In fact Egypt was the first country to introduce the Islamic bank. The Nasser Bank, opened in the sixties as a pool of resources for the poor. It was supported by the state. It offered interest-free loans to the low-paid at favourable terms for social as well as commercial needs and acted more as a social security organization than a bank. In fact, there are various factors that have influenced the demand for the services of Islamic banks. Also the prevailing economic condition of Egypt has facilitated the move towards this direction. During some past years, Egyptian economy has been passing through hard times with current recession effecting the world economy. This in turn has effected the growth rate of Islamic banking.[2]

So far the future of Islamic bank is concerned, it is too early to give a final evaluation of Islamic banking in Egypt. Infact, even though, three decades have passed, the experiments are still at the early stage. Since Islamic banks adhere to the <u>Shari'ah</u>, the challenge has put additional pressures on Islamic bankers to explain their new practices not only to customers but to other finance houses. From their various annual reports it appears that they are very far from having exhausted their potentials. There is a conflict between Islamic and conventional banking in this respect. Islamic banking also has a socio-economic aspect, as it combines the object of profitability with the

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2 Rodney Wilson, 'Islamic Banking and Finance', <u>The Middle East and North Africa</u>, 34th ed. (Europa Publications Limited, 1988), p.160.

importance of meeting certain social goals through the implementation of Zakah, a tax on profit and capital. Funds collected in this way are distributed according to certain criteria to the poor and needy, and their impact on society particularly in developing countries is moral, psychological and economic.[3]

There are considerable amount of criticisms regarding the functions of Islamic banks in Egypt which would mobilise long-term funds. How the banking would affect the economy? What policy will it adopt? The Central operational methods of an Islamic banks guarantees two things: First, one must know the customers intimately and undertake projects in question. Secondly, one must study the project thoroughly to assess its viability.

Islamic banks facing problems in Egypt are generally of two types. The first problem arises from the banking control, procedures exercised by the central bank on all banks including Islamic banks with regard to monetary reserves and liquidity requirements. The second problem relates to the fact that in practice Islamic banks do not have a bank of banks. But despite all these defects, they have been found not only highly competitive

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3 "Islamic Banking in Egypt : the story so far", Arabia (London), February 1986, p.58.

as credit banks but also highly competitive as deposit banks. The religious enthusiasm of all concerned seems to present a major force behind the success of the banks.[4] Banks in Egypt are divided into commercial banks, business and investment banks, and specialised banks. There is no special category for Islamic banks. The Faisal Islamic Bank comes under commercial banks, while the Islamic international bank for investment and development is included in the business and investment bank category. There is

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4 The governor of Faisal Islamic Bank of Egypt El-Helws claims that the philosophy behind the Islamic banks make them capable of fulfilling the role of development banks, as they neither take interest nor regard collateral as a decisive element in dictating investment options. The central operational method of an Islamic bank guarantees two things: First, one must know the customer intimately and determine if he is the right person to undertake project in question, secondly, one must study the project thoroughly to assess its viability. Helows points out that if all banking system adopted this approach, two things would happen. First, all development projects would be studied thoroughly. This would enable the customer and the national economy to avoid the pitfalls of traditional financing. Traditional bankers may not be very strict regarding the viability of a project they finance if they are guaranteed a high rate of interest and collateral. Thus Islamic financing appears to be more suitable for third world countries. The experiment, however, is still in its early stages, and the talk about a totally Islamised banking system can only be theoritical at this stage; Ibid.,p.58.

no Islamic bank in the specialized group, and the Nasser social bank is not included anywhere since it is not registered with the central bank.[5]

The pressure is also coming from other direction. Citizens are now refusing to pay interest. Egypt is a country where majority lives in poor conditions. In this atmosphere calls raised by the Islamic trends are finding many attentive listners. The pressure on the government to comply with the demand of the Islamist is mainly religious. At least two other Islamic banks are being set up and investment companies on Islamic principle are flourishing.

Abdel Aziz, former Egyptian prime-minister ... is known to have a wealth of experience in international finance. He has been closely involved with western banking system as well as playing an active role in the development of Islamic banking. He has also been investment auditor of Geneva-based Dar al-Maal

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5 According to a recent report, the Islamic banks have been at the centre of a political row; A lot of pressure has been put to implement Islamic law and to over turn the Western banking system. The pressure has become so intense lately that normally moderate Mubarak regimes was forced to forsake democratic appearances. For full details, see "Islamic banking joins the Shari'ah Struggle in Egypt", Arabia (London), September 1985, pp. 56-66.

al-Islami and Deputy chairman of cairo-based Faisal Islamic Management, and is currently chairman of Egypts Bank of Commerce and Development. He looks at the world inside potentials for Islamic banking. He says that the development of Islamic banking in Egypt cannot be studied in isolation from the whole concept of economic thought is Islam. Islamic bank cannot function apart from the economic order of the country in which the concept is implemented. They have to develop within an economic framework where they function side by side with other economic units, in trade, industry, agriculture, contracting and so on.

To make this possible, rulers must be drawn up for a financial and monetary system which central bank can adopt. Islamic banking cannot be run within a system of supervision and control which is built on creation of money supply, with capital and liquidity ratio which take into consideration.

In Egypt regulating of Islamic banks by central bank is missing. It is felt that, for Islamic banks to function, the central banks must develop new laws and regulations concerning their use of funds. In particular, central banks need to develop criteria of profit-sharing ratios between current deposit accounts, and recognition of <u>zakah</u> and regulations concerning its expenditure. In addition, some system may be developed for the participation of depositors in annual general meetings of financial institutions, as they are really participants in risk taking or profit-loss sharing. There are many other functions to be revised and new criteria to be developed. According to a study all the countries in Arab world, it is in Egypt that Islamic financial institutions have taken over the largest share - an estimated 30 per cent - of all privately held deposits. The government has been promising legislation to regulate their activities and provide some protection for their depositors, who have been lured by the 24 per cent return they offer. Deposits at regular banks can earn only 13 per cent. In March 1988 however, the government suddenly withdrew the draft law, which had been designed by the stock exchange authority. It would have granted depositors the status of preferred share-holders, giving them priority over other creditors in case of bankrupcy.[6]

However, Hedozy feels that cooperation between Islamic bank and western institution is rather vital. According to him 'since Islamic banks and financial institutions are developing fast in trade and investment, they could cooperate better with western institutions if these institutions changed the rules of the financial game to exclude interest. There has been an understanding

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6 The Economic Intelligence Unit (EUI) Country Report - Egypt, No.2 1988, p.13.

by some western banking, such as financing trade on a participation basis, which means sharing in the risk. Such a system is far more advanced in its judgement of economic feasibility than conventional interest bearing techniques, since it is called for more sophisticated accouting and cost/benefit analysis.

Islamic banking operations do have to be kept separate in terms of their source and application for funds, but this does not preclude close working with conventional systems. One type of bank is wholly run on Islamic basis, but there is another that uses separate departments or branches for Islamic and conventional banking to ensure that funds are not mixed up.[7]

In recent years, billions of Egyptian pounds have flooded into so-called Islamic investment companies providing investors with return of 20% or more. The government is frightened by their growing financial power and wants to bring them under closer control and security. The Islamic investment companies have become so successful that it is attracting the savings of millions of ordinary Egyptians and threatens to pass a serious challenge to the established banking system.[8] Though, these companies are

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7 See Arab Banking File, Middle East Economic Digest, (London), August 1985, p.24.

8 "Money on the Loose", The Middle East (London), January 1988, pp-24.

completely unregulated, but they have been able to attract more than $ 505 billion by offering return as high as 24 per cent. Egypt's commercial banks, with their low interest rates, have deposits totalling only $ 10.5 billion.[9] These companies set up according to Islamic principle pay out profits to depositors which vary according to the success of investment made by the respective institutions. However, if the investment proves to be a failure, then the depositors losses money as well as the company or bank. The Islamic nature of such financing and banking has a strong appeal in Egypt where religious upsurge is a powerful force. The annual dividents of 20% or more (sometimes reaching 40%) have captured public attentions. They are now providing a real alternative to the traditional banking system and even to the existing Islamic banks.

These investment houses such as El-Rayyan, El-Sherif, El-Huda Misr and El-Saad, together with some 20 smaller firms have grown in power and importance far faster than the authorities have been able to respond. The precise nature and true extent of their speculation and investment is unknown, but some estimates put their wealth at round E£ 12 bn ($ 5 bn.) By comparison, total commercial

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9 Country Report - Egypt, (E.I.U.),No.1, 1988, p.10.

bank deposit at the end of the fiscal 1985/86 stood at Ef 26.8 bn ($ 19.8 bn).[10] According to the Economic Intelligence Unit report Al-Rayan is the more powerful of the two, mentioned above. It has perhaps $ 10 billion in deposits and business interests ranging from restaurents, tourism, meat packing and dairy products to consumer goods and property that are concentrated in Cairo and Alexandria. Another Egyptian Islamic investment company, Al-Saad, specializes in construction and small to medium sized manufacturing. It is stronger in the Delta region. It was feared that this merger, positing the companies to blanket the country, was only a first step in creating a monolith that would devor the economy.[11]

The legal position of both of the companies and their depositors is still unclear, and this is causing concern to both government and the companies themselves. Recently, a new law has been passed in the parliament which will make it necessary for the Islamic investment groups to form joint stock companies and

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10 In 1986, El-Rayyan suffered a huge loss on its deposits after rumours circulated of a $ 100 m losses the bullion market. Anxious depositors reached the company headquarters, but everyone who wanted his cash was paid off. El-Rayyan denied the rumours and loudly proclaimed its financial health. See The Middle East, January 1988, p.23.

11 Country Report Egypt, (EIU),No.2, op. cit., p.13.

convert depositor's funds (which at present has no legal protection into shares. The companies will be obliged to publish balance sheets, deposits funds with the Central Bank and get official approval for money to be kept abroad.[12] The phenomenal success of the Islamic investment companies in Egypt can be traced largely to the peculiarities of the Egyptian financial system. Relatively few individuals places their savings in banks and almost all personal transactions are carried out in cash. The rural villager's, unfamiliarity with banks leads people to keep their wealth largely in land on gold. Most villagers would be far happier in entrusting their personal wealth to a respectable elders rather than an anonymous bank. To a great extent, the investment firms owe their origins to such mistrust. These companies,for the utilisation of funds, were initially set up by money brokers engaged in repatriating the funds of Egyptian workers abroad. Many of the labourers abroad were making excellent money in the Gulf and most of them would never have dreamt of putting of putting their savings into a bank. Even today, an estimated 2.2 million, Egyptians work overseas and their remittances make up a large preparation of Egypt's foreign hard currency income. Egyptian national residents in the country have been forbidden to

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12 The Economic Intelligence Unit (EIU), Country Report Egypt (EIU), No.1, 1988, p.10.

hold hard currency which had to be remitted to the banks at the official exchange rate. Village expatriate were far more willing to hand over their earnings to trusted intermediaries rather than deal with the bank themselves; The brokers, in turn, exchanged the hard currency and delivered the proceeds to the worker's families.[13]

According to the Middle East Report, these companies are floating in a legal limbo. Under the Egyptian law, only joint stock companies are licened to invest funds in the manner practiced by El-Sharif, El-Rayyan and others. At the same time it is technically illegal for institutions other than banks to collect deposits and the authorities are worried that the finance houses depositors have none of the legal protection offered to joint stock company. These companies, writes an Egyptian economist, are dangerous. No one knows how many people are involved, how much money is invested and where the money is. The depositors themselves have an uncertain legal status. They cannot be partners under Egyptian law because they made no contribution to the capitalisation of the companies which are owned by individuals or other groups of investors. But as depositors, they cannot deemed to be

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13 See the report published in the Middle East, January, 1988, p.23.

creditor since they receive profit rather than interest. Partners or shares-holders have right to attend annual general meetings and review a company's activities, depositors have none of these rights, nor can they gain access to the books. They are depositors in the holding company and not its subsidiaries, and their legal relationship with investment companies is totally unidentified.[14]

Egyptian governments, it seems, do not favour these Islamic investment companies. The reason might be the revival of Islamic fundamentalism. As James Bedding writers: 'Earlier this year, just before the authorities instituted a free exchange rate, they were appalled by the apparent ability of the Islamic financial groups to manipulate the currency with their large cash reserves. Whatever the political gulf between the well-heeled enterpreneurs of the finance houses and the extremists who have taken pot shots at local politicians and foreign emissaries, the regime is wary of what it may provoke by confronting the Islamic investment companies head-on and upsetting religious susceptibilities.[15]

The investment companies advertising heavily on television project an image of a new kind of enterprise that is Islamic, moral

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14 Ibid., p.24.

15 "Money on the Loose", The Middle East (London), January, 1988, p.24.

and highly successful. Its less than a third of depositor's money ends up in local projects. The rest is held liquid or invested in gold and international market, or used to finance import deals for the government. The El-Rayyan company is able to record massive profits, and the reason, as its chairman says, is due to the fact that only a relatively small proportion of deposits, (about 30%) is invested in long-term projects. Fourty per cent is used for trading-speculation on international stock exchange, import deals on behalf of the government and gold store of some E£ 300,000. This leaves a massive 30% of holdings as liquid assets, which can explain how El-Rayyan was able to pay its depositors in last years loss on the company. A staggering 15% of deposit is held fully liquid for depositors need and 15% more is semi-liquid for instant investment.[16]

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16 In a conversation with the Middle East, the Company's chairman Haqq Ahmad taked about the groups companies. In 1979, one of the three brothers, returned from work in Libya and invested his saving in trading. He was so successful that in 1982, three brothers founded a company, and now, after five years, they hold 16 subsidiary companies which are involved in every-thing from detergent production to jewellary retailing. According to Haqq Ahmad, the company never advertise, for saving. People come to them by recommendation. The 3000,000 depositors have contributed between E£ 2.25 bn and E£ 2.5 bn (approx. $ 1 bn.) an average investment of E£ 7.500; See The Middle East (London), January 1988, pp. 24.

El-Rayyan also has investment abroad. The corporation owns three subsdiaries in Geneva and United States, that deal in seeds, and another speculating companies in Geneva. They have already undertaken projects in Saudi Arabia and plans are being made for more in Jordan.

Under pressure from the Government, El-Rayyan is converting to a Joint Stock Company by asking depositors to convert their deposits into shares in a subsidiary El-Rayyan for financial dealing.

Case Study I : Nasser Social Bank :

The Nasser Social Bank (NSB) can be regarded as the first attempt at establishing an Islamic financial institution in Egypt and indeed the second in the modern Islamic world as a whole. The bank, however, is an extension of and has been founded on, what used to be Mit Ghamr Local Saving Banks, before the latter's name was changed to Nasser Social Bank with state funding in 1971.[17]

The Bank was established in 1963 in a provincial capital, Mit Ghamr, a rural area in the Nile Delta. The driving force

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17 Much of this study is based on the field survey done by Ahmad Abdel-Fattah Ashker El, The Islamic Business Enterprise, (Croom Helm, 1987).

behind the establishment of the bank was Ahmed al-Naggar, an academic with practical experience in local saving banks in West Germany.[18] Notably, although the bank was run on the Islamic basis with the intention of applying the Shari'ah to its operations, such intention was not publicly pronounced by El-Naggar and the bank did not bear the name 'Islamic' in its description. That was meant, as al-Naggar explains, to avoid any possible misconception

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18 He later became secretary-general of the International Association of Islamic Banks and a member of the board of directors of the Faisal Islamic bank of Egypt; see Ahmad al-Naggar, 'Islamic Banks: A Model and the Challenge', in The Challenge of Islam, ed. Altaf Gauhar (London:Islamic Council of Europe,1978),pp. 220-34. The driving force behind the revival of the Mit Ghamr Savings Bank under the new name Nasser Social Bank was Ahmed al-Naggar. He helped establish the new bank in 1972, in which he was appointed deputy general manager. Three factors could be said to have helped al-Naggar in his new endeavour:(1) the decline in the number of depositors and deposits after putting the Mit Ghamr Bank and its branches under the control of commercial banks. (2) the public debate on the issue of local savings banks, which was carried to the Egyptian Assembly (Parliament) and (3) the changes in the government administration under the new President, Sadat.

on the part of the government that the name might encourage the regrouping of Islamic political elements in the country, an idea which was not tolerated by the state. This gives an idea about the political climate of Egypt at that time, the changes in which later on proved to have played a significant role in the history of the bank and the development of Islamic banks in Egypt in general. Instead, the bank was declared as a local saving centre that was run on the no-interest basis to help small entrepreneurs avoid elements of exploitation implied in interest and to encourage saving and boost economic development in the area. That formula seemed to have been ideologically accepted by the country's leadership. The bank was regarded as a public sector institution and was accountable to the state, though it was given a degree of operational autonomy.

Based on the principles of the <u>shari'ah</u>, the Mit Ghamr bank's operations did not deal in interest paid or received. However, a borrower would have to have a deposit account with the bank showing regular savings for at least six months before he could be considered for credit facilities.

The bank's operations were mainly five : deposit accounts, loan accounts, equity participation, direct investment, and social services.

<u>Deposit Accounts</u> :

These are divided into saving accounts and investment accounts:

(1) Saving accounts : these did not bear any financial rewards, but did not incur any expenses to the depositors. There was a minimum amount for opening the account as well as for lodging funds in it, though the amount was almost negligible. Also, the account holder was allowed to withdraw funds from his account on demand.

The idea of introducing these accounts was two folds: to provide individuals with a 'safe-place' to keep their savings' and, more importantly, to develop the habit of saving in individuals. Until 1967, the majority of saving accounts' holders were students,54 per cent followed by blue collar workers, 14 per cent peasants, 11 per cent white collar workers, 10 per cent housewives, 5 per cent minors (under age), 2 per cent and miscellaneous, 4 per cent.

(2) Investment accounts : these were run on the basis of profit-and-loss sharing. The profit share depended on the amount deposited the period of deposit and the amount of profit achieved by the bank from investment operations. Withdrawals from these accounts where on a yearly basis and

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the depositor could not withdraw on demand (except in special circumstances examined by the bank). Conceivably, the bank relied mainly on these funds in financing its investment operations. Until 1967, the depositors in these accounts were as follows: students, 26 per cent; white collar workers, 22 per cent; peasants, 16 per cent; blue collar workers, 13 per cent; minors 'under age), 13 per cent; housewives, 6 per cent.[19]

Loan Accounts:

These were divided into two main types:

(1) Non-investment Loans: these were given (interest-free) to help overcome personal financial problems. However, for a borrower to qualify for the loan he had to have a saving account in the bank for a certain period. There was, therefore, financial motivation to deposit funds in saving accounts. Some borrowers pledged that the loan would not be used for investment purposes. Honesty, trust, personal contact, studying the regularity of deposits in saving accounts and the fear that a future loan application would not be accepted if it was found out that the loan was used for purposes other than that for which it was given, helped the system to operate.

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19 The Islamic Business Enterprise, pp. 156.

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19 The Islamic Business Enterprise, pp. 156.

(2) Investment Loans: these were given for investment purposes on the basis of profit sharing and were paid back on maturity or in instalments. The period of loans ranged between one and five years. This method of finance suited small enterprise, entrepreneurs and craftsmen who had the skill but not the fund to set up their own businesses. Loans covered various activities, mostly of small size, such as the purchase of sewing machines, hand looms for weaving textiles, tools for improving irrigation and farm animals.

Equity Participation:

The Mit Ghamr Savings Bank also participated in enterprise capital as a joint owner, profit was shared between the bank and the entrepreneur in proportion to the amount of capital invested. Also, the bank was involved in the management and financial control of these enterprise, holding a title deed to the enterprise assets.

Direct Investment :

By the end of the second year of its establishment, the Mit Ghamr Bank had started to initiate enterprise on its own. The first of these was the establishment of a brick factory, a product, the demand for which was very high. The second project was the purchase of a private school which had been run by a foreign missionary team which decided to withdraw from operation. Other projects followed a macaroni factory, a semi-mechanised bakery, a mechanised irrigation project, and a dairy. By 1967, total capital invested in these projects reached £.E. 67,000.[20]

Social Services :

A special fund was established by the bank with a view to pooling Zakah revenues paid voluntarily by individuals to be used for the purpose of helping others socially and economically. The social aspect of the bank was emphasised on its establishment, which was seen to be in line with the bank's purpose of improving the economic conditions of the population in the area. Revenues of the fund were mainly Zakah paid by individuals as well as that due on the bank's operations and private donations. Expenses were represented mainly in giving financial help to the needy and interest-free loans to those who did not have savings accounts in the bank.

Before long, the Mit Ghamr Savings Bank prospered, and within five years it opened four more branches in different parts of the province. Also, the number of depositors in the bank as well as in its branches increased from 17.560 of £.E 41,000 in 1963-64 to 251.000 claiming about £.E 1.8m in 1966.67. The success of the bank was notable; problems of rural debt were reduced as

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20 Ibid., p. 157.

borrowers no longer had to depend on moneylenders, many of whom charged a high interest rate. The success of the bank was also commented upon in a Ford Foundation report in June 1967, which praised the bank for winning the personal support of a large number of farmers and villagers who regarded the bank as their own. In the beginning, the Naser Social Bank had started in a modest way with one room and a staff of twenty five persons. The rural people in that region were religious and would not put their savings into any bank because of interest. Moreover, there was hardly any financial institution available to them.[21]

The experiment of the Mit Ghamr Savings Bank suffered a setback, however, in the period from the second half of 1967 to 1971. Owing to the political atmosphere and to different political currents in the administration of the Egyptian government at that time, between left and right, the Mit Ghamr bank and its branches were put under the direct control of the state administration and

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21 R.K. Ready, "The Egyptian Munispal Saving Bank Project", International Development Review, Vol.9, No.2, 1967, pp. 2-5, as quoted by Ausaf Ahmad, Development and Problems of Islamic Banks, (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 1987), p.2.

consequently lost their operational autonomy. The organization of Insurance, one of the state's organisations, took charge of the bank in the second half of 1967 and appointed members to execute the bank's operations - one from the National Bank of Egypt and the other from the Central Bank. The two banks, the National and the Central, were run on the interest basis. Conceivably, operational policies were changed and the basis of interest-free banking was abandoned. It was not untill 1971 when Sadat came to office that the experiment of the Mit Ghamr Savings Bank was revived under the name Nasser Social Bank. The Nasser Social Bank took over the Mit Ghamr Savings Bank, benefiting from the latter's popular goodwill and honouring its outstanding financial commitments.

Unlike its predecessor, the Nasser Social Bank (NSB) was financially supported by the government. This helped the new institution to start operating on a much firmer financial base. Also, the bank was a public sector bank, was owned fully by the state and was under the full control of the government. The head-quarters of the bank was in Cairo.

The principles of operation in the Nasser Social Bank are very similar to those of the Mit Ghamr Savings Bank, though its functions are wider. The Islamic principles are applied to the bank's operations with no interest paid or received. Besides the activities referred to above, the new institution offers a full range of normal banking services, though foreign-exchange dealings are limited and clients are referred to other banks for such operations. Also, the NSB has a wide range of investment activities through equity participation. The Egyptian government registered this bank for its role in the economic development. This bank accepts deposits, participate in establishing and supporting projects with objectives to providing production requirements for craftsman, financing the comprehensive social insurance system and exerting all possible effort to reinitiate Zakah ordinance.[22]

The NSB operations have been successful. By 1979 it had 25 branches and its total deposits reached £.E. 240m. Profits were increasing, reaching £.E. 12m, about $ 17.3m, by 1978-79.

Furthermore, the social responsibility is one of its main objectives. Like its predecessor, the NSB has established a special fund, Zakah Fund, to spend on social purposes. The main revenues of the fund come from Zakah payments and donations, which

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22 See Economic Review, Central Bank of Egypt (Cairo) Vol. XXIII, No.4, 1983, p.4.

increased from £.E. 39,000 in 1972-73 to £.E. 2.8m in 1982-83. In collecting Zakah, the bank has established a number of committees, (reaching 2,000 by 1983) the main task of which is to administer the collection. The committees travel to different parts of the country for this purpose, to reach individuals rather than waiting for individuals to reach them. The number of beneficiaries increased from 5,000 in 1972-73 to 773,000 in 1982-83. Items of expenses are represented mainly in: establishing vocational training centres for artcrafts and manual skills, establishing evening classes for students, contributing to mosque building and religious institutes, projects for studying the Qur'an, medical assistance, spectacles and hearing aids to the needy and other assistance in money. Government financial support to the social role of the bank is also very significant. To reinforce the bank's finance in this particular side of activities, public sector companies have to pay the NSB 2 per cent of their annual profit to be used for the purpose of establishing pension funds for those who do not enjoy pension schemes. Taking into account the broad base of public sector companies in Egypt this provides the bank with a significant source of finance.

The Mir Ghamr Savings Bank can be regarded as the first successful attempt at establishing Islamic financial institutions in modern Islamic world.[23] The bank gained high popularity and goodwill among Egyptians in general and local inhabitants in particular. Despite the hardships that faced the bank, it was a significant experiment for putting Islamic principles into practice, which signalled to Muslims that the _shari'a_ was still applicable to economic issues in the modern world. It is not surprising to know that the Mit Ghamr Savings Bank experiment was studied by many Muslim countries and was the pioneering example for the establishment of the Islamic Development Bank in 1975 and the other Islamic banks that followed. The significance of the Mit Ghamr Bank lay in the fact that it relied on the savings of small investors, managed to mobilise small savings of individuals of limited income, and succeeded in improving the standard of living of many in the area.

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23 A western observer describes the significance of Mit Ghamr experiment in the following way:

"The majority of the population had never been dealing with the financial institutions .... Basically rural and religious they tended to distrust bankers operating in Western style and, what is more, there were few local branches they could patronise since a substantial part of their income was not spent immediately, but put aside for social events, emergencies and alike, this idle capital could not be used for productive investment. A pre-condition, however, for any change of behaviour from herding and "real asset saving" to "financial saving" was the creation of financial institutions which would not violate the religious principles of large segements of population...."; see T. Wholers - Scharf, _Arab and Islamic Banks: New Business Partners for Developing Countries,_ (Paris: OECD, 1983), pp. 79-80, as cited by Ausaf Ahmad, _op. cit._, p.3.

The Nasser social bank is an example of government involvement in the establishment of an Islamic bank, and is a leading example in this field. No doubt, government financial support gives a bank the chance of having a substantial source of finance to rely on if the need arises. However, the problem with such support is that the government tends to put the bank under its own control, and unless the government's ideology is Islamic or Islamic flavoured, the public becomes suspicious of its main purpose and the bank ends up losing the trust of many of its clients.[24]

Case Study 2 : The Faisal Islamic Bank of Egypt (FIBE)

The Faisal Islamic Bank of Egypt is like a joint stock company operating in strict compliance with the principles of the Islamic *shari'ah*. It was founded officially by law 48 for the year 1977, and was inaugurated on 5 July 1979.

The authorised capital of the bank is US $ 500 m, and the paid up capital is US $40 million. Fiftyone per cent of the capital is owned by Egyptians and 49 owned by Saudis and other Muslims.[25]

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24 *The Islamic Business Enterprise*, op. cit., p.161.

25 For the balance sheet of FIBE, see appendix-II

The main function of the bank is to finance investment projects through mudarabah, murabaha and Equity participation. Recently the bank has been concentrating on long-term financing, together with expanding its investment in small industries to help objectives of the Economic Five Year Plan, and to improve the distribution of income and wealth within the country.

Towards this objective, the Bank has established more than 32 companies covering various fields of production such as: livestock, production, industrial production, and medical care, housing and constraction, investment trade, tourism, and many others. One aspect of tne Faisal Islamic Bank is to establish and develop justice, equality, and prosperity amongs all members of society. To realise this, the zakah fund undertakes payments of the legitimately due zakah on the Bank's Funds, in addition to collecting Zakah on behalf of its clients for disbursement in legitimate channels defined in the Qur'an.

The main features of Faisal Islamic Bank is that neither it charges nor gives interest. It offers to finance the different sectors in the form of musharkah, mudarabah and murabahas, in addition to investing in capital projects. It is also different from others when calculating the return on its different finance. No pre-set returns are calculated on musharakah and mudarabah deals. The two sides (the banks and clients) agree to share the net profits resulting from the joint venture. The procedures normally followed stipulates that the client (employer) deducts a certain percentage from the net profits, usually between 20 and 30 per cent, for administration fee. The remaining net profit is the divided between the two parties, depending on each side's financial contribution to the venture. If, for example, the bank contributed 50 per cent towards the finance, its share of the net profit would be 50 per cent and so on.[26]

Over the last five years maximum profits have been exceeded 15 per cent per annum. During the first four month of the present Fiscal year (1405 H) the figure dropped to 12.6 per cent. "It is often said that financial costs in the banks are for higher than those in the commercial banks.[27]

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26 "The risks and costs of non-riba", Arabia (London), July 1985, p.64.

27 *Ibid.*, p.64; As Mohammad El-Helw Governor of Faisal Islamic Bank of Egypt points out that:'The Confusion may have been the result of a misunderstanding of financing deals and operations in the Islamic banks, as well as of the way the profits are calculated in relation to finance cost. When for example, an Islamic banks accepts a customer entering a deal of *Musharkah* or *mudarabah* and offers the finance necessary for this kind of deals agreeing to have a 50 per cent shares of the profits, the bank's 50 per cent of the net profit is in no way the finance cost, for this figure is part of the new profit and not of the total value of financed offered.

As for *Murabaha* deals, the bank (FIBE) and the client agree to the sale of the goods traded on a *murabaha* basis to which are added the bank's profits from the deal to the costs of buying the goods. There is no doubt that a client always compares this profit margin and the cost of financing available from other sources: he would never agree to the bank's making profits that exceed alternative financing costs from other sources.

The Islamic bank, moreover, is liable to be exposed to more risks than other banks. For example, an Islamic bank's liability starts from the very movement, the goods are transported from the site where these were bought, and only ends when the goods are actually delivered to the clients. Again, the clients may delay repayment of *murbaha* premiums (instalments) as a result of liquidity problems. This FIBS will have to put up with without any compenoation for the period of delay, except for rare occasion when such a delay cannot be truely ascribed to liquidity problems, whereas other banks are not concerned with the risk of transportation, shipping, loading or unloading and so on, taxing the client by making him pay interest on his debited account irrespective of his circumstances.[28]

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28 *The Islamic Business Enterprise*, op. cit.,

The return which the (FIBE) charges are the same whatever the currency used in the deal. Commercial banks, on the other hand, differentiate between finances in Egyptian pounds and those in US dollars, the latter always varying and being index-linked to the rates of interest on the International money market.

The Faisal Bank charges no commissions, fees, or expenses of the kinds charged by commercial banks. It has been noted that the greatest part of the commercial bank's finances are of the short-term kind aimed at financing trade and providing security to industrial companie's actual capital. Faisal Bank finance operations, on other hand,are limited to middle-and long-term operations extending, in the case of industrial and manufacturing companies, over a period of nine months to cover production lines. The finance period in this sector as well as in other production and services sectors such as housing, include a grace period sufficient to cover the time for construction, during which no premium or instalments are due.

It is quite clear that the modest figure belowis a reflection of the fact that the Islamic bank does involve itself in all the risk to which its clients may be exposed, most important of which is the period for repayment which is expected to be much longer than agreed due to the market circumstances at present.

Finally, all the returns, revenues and profit effected by the Faisal Banks are distributed to investors. Investment accounts with the Faisal Bank now exceed on millions. Profits are distributed quarterly.[29]

Faisal Islamic Bank has been engaged in financial operations and to a suitable degree, investment activities are diversified. The bank has also shown a continuous growth in deposit as the table below shows:

Total Deposits, FIBE 1979-84 (in US $ Million)

1979	1980	1981	1982	1983	1984
23.6	140	469	792.5	1216.7	531

The only breakdown available from the years 1979-84 is the one for 1979, which suggest that the total deposits, the main part was due to investment accounts, amounting to about $ 16 million as 68 per cent of the total, there were current accounts of about

29 Arabia (London), July 1985, p.65.

$ 7.2 million or 30.2 per cent of the total and the negligible amount of $ 33, 408 as 1.5 per cent of the total was saving account. The growth in saving account has been negligible and sharp increase in total deposits follows very closely the growth of investment accounts.[29]

According to El-Helw, governor of FIBE, most of the bank's financing is in Middle and long-term operations which accounts for more than 50 per cent of activities and in distribution of short-and medium-term financial operations, being 53 per cent (services including housing and transport), 32 per cent (industry) 8 per cent (commerce) and 7 per cent (agriculture).[30]

However, lack of involvement in productive investment does not necessarily rule out financing related to manufacturing on a short-term basis. A better picture can be obtained on this by looking at the share of the bank's direct investment and equity participation in the projects in comparison with the total assets.

In 1983, out of total assets of $ 1504 million, only £ 86 million was direct or equity investment, that is no more than 5.7 per cent of total assets. By 1984 however, out of a total of

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30 "Faisal Islamic Bank of Egypt: an assessment", Arabia (London), November 1985, pp. 63-64.

$ 1861 million, a mere $ 95.5 million was in the form of direct or equity investment, that is about 5 per cent of the total and a drop of 0.7 per cent over the previous year. The numbers of projects were 26 and 31 for 1983 and 1984 respectively, suggesting that short and perhaps medium term of trade of various forms are the major part of FIB's assets.

Finally, it would be interesting to find out how FIBE has been affected by the recession. This may be reflected in access of supply of funds relative to demand and as a proxy for this we have combined the figures for "cash in hand" and 'cash with banks and correspondents" to obtain the amount of idle cash available and it is shown in the below figure.

Idle Cash and Geographical Dist. [illegible]
of Funds 1980-84 (in $ US Million)

	Cash	Domestic Employment of Fund	Foreign Employment of Fund
1980	34.6	18	109
1981	191.5	71	219
1982	137	320	458.5
1983	179.6	607	652
1984	235	758	749

From the above table, it is clear that with the deeping of the recession, the magnitude of the problem has grown. Idle cash was $ 34.6 million in 1980 and $ 235 million in 1984 an increase of 579 per cent over the period.[31]

Although the policy of investment abroad initially seemed a successful move, the gap between the home and foreign employment of funds has narrowed considerably since with nearly equal amounts on each side in 1984.[32]

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31 *Ibid.*, p.64.

32 Both El Helw and Ahmad Amin Fuad, Chairman of the Cairo-based International Islamic Bank, argue that the recession has hit Islamic banks harder than traditional banks. El-Helw arguments hinges on the assessment that most of the FIBE's clients are small and medium business. They are likely to be hit harder by the recession and do not have large reserver to fall back on. In any case the Islamic banks suffer when the business is bad regardless of the assets of the client, because its profit is calculated on the deal in question itself.

Fuad adds that Islamic banks are suffering because they have fewer options for investment than traditional banks and are hampered by the stiff regulations which have not yet been adopted to the operations of Islamic banks.

Both bank chiefs, however, say that they are satisfied with the performance of their institutions inspite of the adverse circumstances; see *Arabia* (London), November 1985, p.64.

Expenditure of the Fund :

The total amount of Zakah paid to individuals during the year 1405 amounted to £ E. 654,887 compared to £ E 60.446 during 1401H.[33] An amount of £ E 784,214 was paid in money and other kind (as housing, clothes, foods and compensatory aids), to poor and needy students of University, higher institutes, Al-Azhar institutes and school during 1405 H in comparison to £ E 34,525 during 1401 H. And £ E 66.054 was paid out for the maintenance of mosques during 1405H compared to £ E3,200 during 1405H. £E 138,408 was paid to 37 registered private societies in 1401H. This compares with £ E 62,900 paid to six societies during 1401 H for social services to poor and needy individuals.

The sum of £ E 4,650 was paid out to 21 persons from 310 participants in the annual competition for the Memorisation of the Qur'an during 1405H.

The Fund has allocated £ E % 50,000 in its planned Estimates for 1406 H, to furnishing poor craftsmen, who are capable of working but lack capital, with production requisites and the equipments necessary for them to operate.

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33 For the Zakah Fund revenues and expenditure of FIBE, see appendix III

Zakah paid by individuals for the year 1405 H amounted to £ E 114.421.

Donation received from persons during the year 1405 amounted to £E 38,440 in comparison to £E 11.748 during 1401 H.

Socio-investment accounts for the year 1405 H amounted to £ E 410.876 (US) 167.474) compared to US $ 10,000 during 1401H.[34]

Resources of the Fund :

To fulfil the interaction between the economic and social dimensions, the Faisal Islamic Bank of Egypt established Zakah Fund. The aim of the Fund is to pay the due Zakah on the share-holder's fund of the bank as well as to collect Zakah on behalf of investment account holders. These funds are disbursed through Shari'ah.

The following is the brief statement of the Zakah development of the Zakah fund's resources and expenditure.

1. Zakah due on the Bank's fund (share-holders) for the year 1405 H amounted to £.E $ 549.650 compared to £ E 244.324 charged to the Fiscal year 1401 H.

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34 Arabia (London), October 1986, p.45.

2. *Zakah* collected from clients (investment account holders) for the year 1405 amounted to £ E 602.507 compared to £ E 20.659 during 1401H. This increase reflect the client's confident in the Bank to distribute their *Zakah*.[35]

In the matter of financial resources, the FIBE provides more credit than other banks. This is because of its special relationship with its depositors which is based on the profit and loss sharing basis. Since the depositors in the FIBE are not guaranteed either a fixed income or the repayment of his deposit, FIBE is in a position to transfer part of the risk involved to the depositor, while other banks do not. The high growth in the bank's deposits, compared with that of other commercial banks, can be related to two major factors: the religious factor which motivates Muslim savers to save in an Islamic bank, and the return factor, where the bank's rate is higher than the rate of interest in non-Islamic banks.

Case Study 3 : Islamic International Bank for Investment and Development (IBID)

This bank was established in 1980 by ministerial decree in accordance with the Investment Law of Arab and Foreign Funds and Free Zones Law, no. 43 of 1974.[36] It was registered with the

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35 *Ibid*., p. 45.

36 All the subsequent figures on IBID are from Ahmad Abdel-Fattah Ashker El., *The Islamic Business Enterprise* (Croom Helm 1987

Central Bank in November 1980. The Islamic International Bank for Investment and Development (IBID) was established in the form of a joint-stock public limited company. The liability of shareholders is limited to the amount of capital for which they have subscribed.

The general characteristics of shares are similar to those of the FIBE. Shares cannot be divided into fraction of shares, they have nominal values (par value), the nominal value per share must be in the range of £.E. 5.00 minimum and £.E. 1,000.00 maximum and at least 25 per cent of the shares should be offered to the public.

The authorised capital of the bank is $ 100m. divided into 10,000.000 shares of $ 10 per value per share. The issued capital was $ 12m until the first half of 1984, after which it was increased to $ 30 m (according to the decision of the annual general meeting on 25 June 1984). The paid-up capital increased from $ 4.875m to $ 5.638m and $ 8.647m to 11.42m in 1981, 1982, 1983 and 1984 respectively. All the founders of the bank are Egyptians. Its initiative and capital is therefore entirely Egyptian, unlike that of the FIBE.. The success of the FIBE and its effect in investors' willingness to invest in the new bank (IBID) cannot be ignored, however.

Similar to the FIBE the bank has a board of directors, a religious supervisory board, and a general meeting. The characteristics of these boards are very similar to those of the FIBE.

The bank offers all banking operations in Egyptian and foreign currency as follows:

(1) Opening all bank accounts and accepting all kinds of deposits.

(2) Performing and undertaking all operations relating to securities, shares and similar stocks in local, Arab and international markets; creation and management of investment fund systems in various commercial, agricultural, real estate, industrial and other activities.

(4) Innovating solidarity and security funds to face any possibility of loss which may inflect the bank's clients, in compliance with Islamic co-operative systems.

(5) Issuing of Islamic promissory notes on behalf of third parties and the receipt of relevant subscription.

(6) Providing technical, economic, financial, managerial marketing and consultancy services relevant to projects, and preparing of feasibility studies.

(7) Financing and setting up all kinds of projects either for the bank's own account or for the account of or in participation with other parties.

(8) Contributing to the creation, development and promotion of investment in all sectors of development by establishing new projects and/or expanding and upgrading existing projects.

(9) Carrying out all banking, trading, financial and investment operations based on partification or other forms consistent with the provision of the _Shari'ah_.[37]

Current Accounts :

The general features of current accounts in the IBID are similar to those of the FIBE. The accounts are not entitled to any return, they are on-demand accounts, they may be opened in different currencies, amounts may be transferred from them to any other accounts etc. Also, the client's religion is not a barrier.

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37 _Ibid_., p.144. For the balance-sheet of IBID; see appendix IV.

Savings Accounts :

The general features of these accounts are similar to those of other accounts, also, a minimum amount is required to open the account: £.E. 300 or the equivalent in other convertible currencies. Savings accounts have some features of current accounts and some of investment accounts. Cheques is also allowed provided a minimum balance is maintained at £.E. 150 or equivalent in convertible currencies.[38]

Savings accounts are entitled to a return based on the profit- Sharing principle, calculated on the minimum monthly account balance. However, the striking feature of this return is that it is distributed at the direction of the board of directors which has the right to determine how much will be distributed, or indeed if there will be a distribution at all. The decision of the board in this respect depends upon how much profit is made in a year - higher profits are associated with higher returns. The return, which ranges between 3 and 6 per cent, is regarded as a 'gift' from the bank. Compared with investment accounts, savings accounts are less risky; the account fund cannot be reduced by any losses the bank may suffer. Therefore, this type of account suits the the less adventurous investor.[39]

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38 Ibid., p. 145.

39 Ibid., p. 146

Investment-savings Accounts :

These accounts were introduced in order to encourage the investor to invest with the bank and meanwhile to give him access to his savings without being tied up in investment for a long period. They have the following characteristics:

(1) The client may freely withdraw from his account up to 40 per cent of the balance, 60 per cent of the balance remaining invested.

(2) The client is entitled to a profit-sharing return calculated on 60 per cent of the lowest monthly balance.

(3) The total return to the client from this account consists, therefore, of two parts; the first is a portion of the investment profit (on 60 per cent of the minimum monthly balance), and the second is a 'gift' portion determined at the discretion of the board of directors (similar to savings accounts) on 40 per cent of the minimum monthly balance.[40] To qualify for the gift portion, the client should maintain the minimum balance stated in the section on savings accounts.

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40 Ibid., p. 147.

Investment-savings accounts bear two types of risk, one higher than the other. The first concerns the 60 per cent portion of the account, which may be lost entirely or partly in case of a major loss on investments impairing the capital. The second concerns the 40 per cent portion, which can be virtually ignored, unless the bank goes bankrupt.[41]

Investment Accounts :

Investment accounts have the following characteristics:

(1) They are accepted in different currencies for a minimum initial amount of £-E 1000, or the equivalent in convertible currencies.

(2) Replenishment of accounts is accepted on the basis of 50 per cent of the above minimum.

(3) The periods of accounts are six months, one year.

(4) Deposits may not be withdrawan during the deposit period except for crucial conditions accepted by the bank management.

(5) Deposits are renewable automatically for the same period unless contrary advice is given in writing seven days prior to the maturity date.

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41 Ibid., p.

Average Rate of Return on Investment Accounts

Year	Average rate of interest %	FIBE rate of return %	IBID rate of return %
1981	8.5	12.5	13.1
1982	8.5	10.9	13.2
1983	9.0	10.1	13.0
1984	9.0	9.0	10.0

(6) Depositors are entitled to a return on the profit-sharing basis, calculated monthly. However, they are appropriated to clients on a quarterly basis, except for six-months deposits, which are appropriated on maturity.

(7) Returns are credited to clients' current accounts in the same currency as the deposit, quarterly or bi-annually depending on the time deposit basis.[42]

In fact the IBID's rate is higher than that of the FIBE. The rate are shown in the figure which provides a comparison between the average rate of interest on deposits (in non-Islamic banks,) the average rate of return of the FIBE and that of the IBID.

42 Ibid., p. 147

In this respect, it seems that the IBID performs better than the FIBE.

Various factors can be said to have contributed to the growth of deposit funds in the IBID (which also applies to the FIBE) :

(1) The desire of Muslims to invest their savings in accordance with Islamic principles, a feeling which is enhanced by the growing move of Islamic resurgence.

(2) The increase in the remittance of Egyptians working abroad, transferred to Islamic banks, though this is an important factor, it is but one. Remittance transferred is not the only source of deposits to Islamic banks, deposits originate also from local savings. Also, not all Egyptians working abroad are Muslims, and for those who are, not all of them are prepared to invest their savings in accounts with no fixed interest.

(3) Trust in the management of Islamic banks.

(4) The success of Islamic banks, which in its turn increases investors' trust in the efficiency of management and so on.[43]

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43 For more detailed account of Islamic banks' performance; see Islamic Business Enterprise.

Financial Facilities :

The IBID provides financial facilities for various types of projects: agricultural, industrial and commercial. The facilities can be broadly classified into short term and medium and long-term operations.

Short-term Operations :

The basis of these operations, which is common to Islamic banks in general, is :

Murabaha : The bank supplies clients (willing to buy) with their requirements (equipment, means of transportation, raw materials, commodity requirements, etc.) taking the following factors into account.

(1) The bank makes enquiries about, buys, owns and then sells goods to the client.

(2) The bank as a buyer takes the full risk of the purchased goods.

(3) Once the goods are sold at a higher price (purchase price plus profit margin) under terms of payment mutually agreed upon with the client, the bank cannot calculate any further increase due to delay in repayment on instalments on maturity dates.

The interesting point here which characterises the IBID murabaha and makes it different from that of the FIBE is that the IBID does not calculate any further increase due to delay in repayment of instalments on maturity dates. From the FIBE case, ~~that~~ the bank is of the view that since the delay causes harm to the bank in terms of profit forgone, the bank is entitled to compensation calculated on the basis of the average annual rate of return realised on the bank's investment funds. The IBID's policy is more lenient and beneficial to clients who might not be able to pay on maturity. This policy does not necessarily encourage clients not to pay in time: clients take into account the effect of any delay in their payment on their 'historical record' with the bank and the impact of that on future operations. The policy, however, requires the IBID to be more selective in accepting clients for these operations than the FIBE, and it implies that a thorough scrutiny of clients' applications is highly necessary.

Musharaka (participation): The bank together with its clients, partly finances operations in the fields of import, export internal trading, contracting etc. The client gets the return of his effort and expertise on the basis of a percentage of the profit which is estimated but not known in advance. The appropriation is calculated on the basis of the actual profit achieved.

Mudaraba : It is practically like Musharaka except that the bank finance the operation in full, while the client participates with his effort and expertise. Oviously, the client's history, conduct and expertise are essential for undertaking these operations. However, these operations tend to concentrate on small business which depend heavily on expertise with small capital, such as small art and craft workshops. The relative size of the operations in relation to Murabaha and Musharaka is very small, less than 10 per cent.

As for the degree of risk involved, it can be seen that the risk associated with mudaraba is the highest, followed by musharaka and murabaha respectively. This explains why mudaraba operations revolve on the small type of business that does not require large capital: the partner does not provide any capital'.[44]

Taking into account the recent origins of these Islamic banks, their performance are not insignificant. As for the deposits are concerned, these banks are quite competitive in acquiring deposits, particularly time and saving deposits. This shows that Islamic banking provides productive outlet for investable resources. The increase in the saving deposits indicates that in vestors appreciate this type of investment.

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44 For the financial operations of IBID; see appendix V.

There is no special entity for Islamic banks in Egypt. Banks in Egypt are divided into commercial banks, business and investment banks and specialised banks. Their financial position is included in the total data with commercial, business and investment etc.

Whatever information available to us on the functioning of these financial institutions in Egypt, it appears that their existence is at individual level. This is a big drawback for their development. To make them successful, however, rules must be drawn up for a financial and monetary system which central bank can adopt. Central bank, in this connection, must develop new laws and regulations concerning their use of funds. The lack of adequate financial instruments, including trained banking staff, and moreover, the means for dealing with higher informatio[n] and transaction cost to both depositors and banks. All these and many other problems are first to be resolved for the success of Islamic banking system.

CHAPTER - VII

EXPERIMENTS IN ISLAMIC BANKING - SAUDI ARABIA

Saudi Arabia's banking system consist of central and commercial banks. The Saudi Central Bank was created in April 1952 in Jeddah under the name Saudi Arabian Monetary Agency (SAMA) untill,- then the country had no centralized monetary authority. Foreign commercial companies like Gellatly, Netherlands Trading Society, served as bankers to the states. SAMA's head office is in Riyadh; it has 10 branches, located in the town Abha, Buraidah, Dammam, Jaizan, Jeddah, Mecca, Medina, Riyadh, Tabuk and Taief.

Saudi Arabia's banking sector is strictly controlled by the government. SAMA is also vested with special powers like (1) power to issue currency and stabilize fluctuations (2) to control the management of commercial banks. However, Islamic law, the shari'ah, denies two major attributes common to central banks. These are discounting bills at high rates to control bank credit, and open market operations (treasury bonds) to mop up excess liquidity. Deprived of these tools, SAMA strives to use powers vaguely termed "moral persuation".

The banking control law promulgated in June 1966, established the rules other than that banks operation in Saudi Arabia must conform to the <u>shari'ah</u>, which regards interest payments as usuary. Thus, interest returns are replaced by "service fees". The "service fees" on credits from private banks vary between 7% and 8.5% depending on the type of loan.[1] SAMA occasionally adjusts the rate taking into account general economic conditions, the needs of various sectors, and world money market developments. The "service fee" is lower on saving accounts and time deposits ranging between 2% and 4%. In 1980, time deposit came to 35.1% of demand deposits or 21.3% of total deposits compared with 14% and 12% respectively in 1976.[2] In Saudi Arabia there has been considerable support for Islamic banking, even though the kingdom had

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1 Although Saudia Arabia have a prohibition on all interest payments and receipts under their Islamic laws, neverthless the service charges are permitted on bank loan, and in practice, as they are calculated on a percentage basis, they resemble interest in many respects. The service charges are fixed, however, and hence borrowers are not subject to the uncertainity as to the future cost of debt servicing which arises when interest rates vary. In Saudi Arabia most bank deposits are in current accounts which earn no income, but even deposits in saving accounts only earn a modest fixed return. See Rodney Wilson, 'Islamic Banking and Finance', <u>The Middle East and North Africa</u>, 34th Edition, (Europa Publications Limited, 1988), p.160.

2 See "Saudi Arabia, Banking System", <u>Arab World File</u> (Cyprus), April 1982.

no specifically Islamic banks untill recently. A member of the Saudi royal family, prince Muhammad al-Faisal Al-Saud has continued his pursuit in the expanding of Islamic banking.[3]

The following institutions provide loan as interest-free:

1. The Public Investment Fund: (PIF)

It is also known as the General Investment Fund. It was set up in 1971. This fund is responsible to the Ministry of Finance and National Economy. The Fund is supposed to promote the diversification of the economy mainly by lending interest-free to public corporation and by subscription to their bond issues. The PIF's most important consideration is the commercial viability of the project which must also be of some significance in the over all development of the country. Until early 1980, the PIF had

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3 In June 1981, Muhammad Faisal Al-Sa'ud announced the establishment of a $ 1 bn investment holding company, Dar-al-Maal al-Islami (DMI). The purpose was to 'provide the opportunities to Muslim to perform their transactions in accordance with the Islamic shari'ah. The projected capitalization was the largest of any Islamic bank. In December 1982, Faisal announced that the initial private and public offerings had raised $ 310 million from 14,500 share-holders. He also negotiated with other Arab States to open additional banks; see Middle East Contemporary Survey, Vol.7 (New York: Holmes & Meier Publishers, Inc. 1982-83), p.247.

extended loans worth SR 16 billion to Saudia and Perromin alone, and had approved a request by the Saudi Arabian Basic Industries Corporation (SABIC). The PIF's equity acquisition totalled SR 7.2 billion at that time. In 1981, the PIF disimbursed more than SR 10 billion to launch petrochemical, metallurgical and refining complexes in Jubail and Yanbu. The shares of the newly incorporated public corporations are to be sold subsequently to low income Saudi nationals.[4]

(2) The Real Estate Development Fund: (REDF)

It was set up in July 1974. This fund also grants interest-free loans for the construction of private houses or housing complexes. For the former, the credit covers up to 70% of costs and for the latter, 50%. If repayment proceeds regularly upon the maturity of each instalment, the beneficiary enjoys a 20% reduction of his debt; if the credit is rapid before the maturity, a further 10% reduction is applicable. In 1978, the REDF designed four types of medium (10 years) and long-term (25 years) housing loans for between SR 100,000 and SR 200,000. From mid 1975, when the first loan was granted, the REDF had extended over 200,000 long term credit worth some SR 40.5 billion

4 "Saudi Arabia, Banking System", Arab World File, (Cyprus), 19 May, 1982.

for the construction of private houses, and 7,500 medium term loans totalling SR 1.8 billion for 1,500 apartment buildings.[5]

Over the past few years SAMA took measures to enforce regulation of the banking sector. To date, SAMA's approach has been fairly protective towards local commercial banks. Among recent developments in this vein has been a clamp-down on money lenders, whose activities previously fell outside the regulatory process and effectively undermined the operations of commercial banks.[6] SAMA has also excluded foreign banks from Saudi riyal-syndicated lending within the Kingdom.

In February 1984, the agency experimented with a 90-day bill, which it termed a "banker's security deposit account". This issue was undersubscribed by the commercial banks but SAMA claimed

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5 "Saudi Arabia Banking System", Arab World File (Cyprus) May 1982.

6 Most Saudi citizens do not maintain accounts with the commercial banks in the Kingdom. Instead they resort to money lenders and money-changers for their financial requirements. Some of these 'informal' bankers offer a wide range of financial services, including the exchange of currency, the handling of overseas remittances, deposit facilities and loans. Interest is not earned on loans, which are often in kind rather than cash. For example, if a client needs some item of equipment, the money-lender will usually purchase it on behalf of the client and then either collect instalments from the client, or else enter a leasing arrangement. In either case the payments over a period will exceed the initial cost of the item, the difference representing the money-lenders profit; see Rodeny Wilson, 'Islamic Banking and Finance', in The Middle East and North Africa (Europa Publication Limited, 1988), p. 161.

to be pleased with the response, officials stressed that the instrument was not for debt financing, but to provide domestic banks with an outlet for investment.

However, despite the governments commitment to balanced budget over the next five years, the possibility of deficit financing cannot be ruled out, given the short-fall in oil revenues clearly, government borrowing would open up more business opportunities for the domestic banks.[7]

According to the ABF report 'Development of the Saudi commercial banking sector over the past ten years would seem at first right to offer little reason for disappointment. The 11 commercial banks had 524 branches by 1984, compared with only 76 in 1975. Total assets had risen seven-fold to SR 145,000 million ($ 39,720 million) while deposit had increased from SR 15,000 million ($ 4,104 million) to SR 109,000 million ($ 29,859 million). Between 1979-84, total foreign assets had grown to SR 67,000 million ($ 18,354 million) from SR 17,000 ($ 4,657 million).

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7 See "Arab Banking File" MEES, August 1985, p.4

There have, however, been some significant changes in the past two years, highlighting the harsher economic climate in which commercial banks must operate. According to the same report the banks are still profitable, but margins are declining. The two big, wholly Saudi owned banks, National Commercial Bank and Riyadh Bank - with combined assets of $ 25,200 million and over 280 branches - saw their pretax profit last year drop to 0.92 per cent and 1.92 per cent of assets respectively, 'And for the first time since 1979, the total assets of the country's commercial banks fell in 1984 as public expenditure dropped to its lowest level.[8] The report further says : Chief among factors affecting commercial banks future performance will be the level of oil revenues. These will determine public spending and, in turn, the growth of the economy. In June 1985 oil production fell to as little as 2.5 million barrels a day (b/d) a quarter of 1981 output.[9]

The fourth five-years development plan (1985-90) puts total government spending at SRI million ($274,000 million) including military requirements - some SR 200,000 million ($ 55,000 million) less than was spent in the previous five years. This more modest level of expenditure will undoubtedly translate into a healthy

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8 Ibid., p.4.

9 Ibid., p.5.

but relative low growth rate for the non-oil economy. During the first years of the third development plan (1980,85) non-oil gross domestic product (GDP) grew in real terms by 10 per cent a year for 1981 and 1982.and by 7.2 per cent in 1983. Despite the cutback in spending, provisional estimates put growth at 4.3 per cent for 1984. The fourth development plan target is 2.9 per cent a year for the non-oil economy, with over all averages growth for oil and non-oil sectors targeted at 4 per cent.[10]

A number of factors will influence the direction bank take. They are already wary of becoming too involved in the construction sector, with infrastructural development largely complete and the drop in public spending further restricting the number of contract awards. The fourth development plan targets construction growth at 2.8 per cent a year. Although opportunities will remain for banks in this sector, they must be well researched. Over-investment and cash.flow problems have placed demands on the banks in the past, but as emphasis turns to boiling out contractors which have fallen into difficulties, and assisting with financial restructing, there is a need for particular caution. Meanwhile, banking services are still required for the continuing construction activities in those favoured sectors - human a higher proportion of government money than other areas.[11]

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10 Ibid., p.6

11 See "Banking on The Middle East", The Middle East (London), December 1987, pp. 41-46.

Historically the commercial banks have been financial "gap-fillers" in Saudi Arabia: unable to compete with the cheap finance offered by state owned institutions such as the Saudi Industrial Development Fund (SIDF) and the Real Estate Development Fund, they have tended to concentrate on sector whose access to government subsidy is more limited. These have included international trade and certain areas of construction such as office building and housing for foreign workers.

Trade finance remain a major activity of the banks, but its relative importance may diminish in future years. Reduced government spending has led to a decline in importer that is likely to continue as import-substitution industries start-up. Given the risk and uncertainty often attached to domestic lending, and the absence of sufficient outlets for funds, the commercial banks have been attracted to investment overseas. This could be accentuated in future by the opening of still more foreign branches. Considerable private wealth continuous to be directly invested abroad, and the growing respectability and maturity of the Saudi banks should be an important factor in attracting more of this business.[12] One Saudi Arabian money-lending and money-changing

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12 One gap which the commercial banks have been reluctant to fill is that of small business finance. Saudi Arabia's non-oil economy is almost entirely composed of small-scale enterprises. But the needs of the modest entrepreneurs have yet to be accommodated. However, it is hoped that as small firms grow more accustaned to drawing up annual financial statement, commercial banks will find it a easier to assess the viability of financing them, and will be attracted into the market (ABF, August 1985), p.4.

family, the Ar-Rajhis, have grown to become the third largest commercial financial institution in the kingdom, after the National Commercial and the Riyadh banks. Their assets exceed $ 180 million, and all of the business has been built up on the basis of riba free transactions. In 1983, there were pressures on the Ar-Rajhis to register as a commercial bank, as, unlike the other banks, they did not hold reserves with the Saudi Arabian monetary Agency and were completely unregulated. Rather than register as a conventional commercial bank, the Ar-Rajhis decided to seek Islamic banking status, as they claimed their business methods conformed to Quranic principles in any case. There were some hesitation on the part of the Saudi Arabian Monetary Agency, given the implication for the other banks, and the problems in acting as lender of the last resort for this type of financial institution. In the end, however, the Saudi Arabian Monetary Agency decided to license the Ar-Rajhis officially in 1985 as deposit takers and exchange dealers, largely in order to help safeguard the stability of the domestic financial system. Although the monetary agency is not obliged to act as lender of the last resort with respect to institutions such as the Ar-Rajhi, it is widely believed that it would if the need arose.[13]

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13 Rodeny Wilson, 'Islamic Banking and Finance' op. cit., p. 161.

Islamic Development Bank :

The Islamic Development Bank (IDB), created in 1973, was inaugurated in 1975 and began its activities in October 1976. The purpose behind its establishment is to promote solidarity among the different Islamic countries. By the end of April 1978, 32 African and Asian countries had become member states. The bank's head-quarters are in Jeddah.

Organisational Structure :

The board of governors is the bank's highest authority, it is assisted by a board of directors and its chairman, by one or several vicé-presidents and by the administrative personnel. Each member state is represented on the board of governors by one governor and one deputy governor, the latter having voting power only in the absence of the governor. The president of the IDB is elected, for a 5-year term, from among the governors at the board's annual meeting. The board of directors is composed of ten members elected for 3 years, renewable by the board of governors, directors cannot be governors. The board of directors is responsible for the bank's operations and for executing the decisions of the board of governors.

Each member state is entitled to 500 votes plus one vote per equity share (110,000 Islamic dinars). The decisions are taken by simple majority, with the exception of those involving the orientation of the bank's policy and objectives or the supervision of special funds.

Objectives and Operations :

The bank's objective is to promote the economic and social development of the Islamic peoples and communities in accordance with Islamic shari'ah. This means that it does not collect or pay interest; while its status provide for the repayment of its administrative expenses. The IDB is entitled to carry out the following operations: (1) participating the capital of member states' productive projects (2) investing in public or private sector projects (3) managing funds destined to serve Muslim communities in non-member states (4) supervising private funds (5) accepting deposits and obtaining funds by any other means (6) contributing to the development of the member state's foreign trade (7) granting technical assistance to member states (8) providing means for the training of the personnel working in the various projects financed by the bank (9) conducting the necessary studies for the economic and social development of member states.[14]

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14 See 'Islamic Development Bank', The Middle East and North Africa, (Europa Publication Limited, 1988).

Capital and Other Resources :

The bank's unit of account is the Islamic dinar (ID), it has an authorised capital of ID 2 billion divided into 200,000 shares it may be increased by a two-thirds majority of the board of governors initially set at 50%, the paid up capital has been reduced to 37.5% and is distributed as follows:

Operation :

The operations of the Islamic Development Bank are classified into four main categories:

1. Loans to the least developed countries to assist them to build or extend their infrastructures.
2. Financing in the form of equity participations.
3. Financing of the member countries foreign trade.
4. Technical assistance in the form of financing feasibility studies.[15]

In the past ten years, between 1975/76 to 1984/85, the Islamic Development Bank has instituted multiple modes of financing in accordance with the Islamic shari'ah law.

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15 For detail figures of countrywise operations by Islamic Development Bank; see appendix VI.

After the experiment stage, the bank successfully cooperated with various international and regional agencies and funds. In ten years, the IDB approved 575 projects valued at ID 4,858.99 million contributing to the socio-economic development of the Islamic conference Organization's (ICO) 43 member countries. Since countries needs increase more rapidly than available dunds, the IDB has formulated a five-year plan (1985/86 to 1990/91) which forecasts: (1) estimates for ID 270 million for 1985/36 and an annual growth of 10% (2) distribution of modes of financing for the same period as follows: loans; 30%; equity; 10%; leasing; 56%; technical assistance: 4% (3) an accrued diversification of modes of financing to mobilize resources through capital participation and Islamic certificates of deposit and investment, these two modes being in the process of formulation.[16] Furthermore 1984/85 witnessed the readmission of Egypt to the IDB after a suspension of more than five years.

The Islamic Development Bank has completed the first decade of its development. During this period, its membership has increased to 43 countries. Having become operational in the very first year, it has carried out about 250 ordinary operations totalling nearly US $ 1.5 bn. The foreign trade financing made

16 Figures for different modes of financing are available in Appendix VII.

available by it upto about US $ 4 bn. Additionally, it has undertaken about fifty operations from its special account which would add another $ 150 m approximately to the financing provided by the Bank since its inception. Its financing has taken the form of loans, equity investment, leasing, profit-sharing technical assistance and foreign trade operations. It has restored to three other types of operation known as Line of Equity, line of Leasing and Instalment Financing. Viewed from a sectoral standpoint, it has covered several sectors, such as industries and mining, transport and communications, agriculture and agro-based industries, utilities and social services. It has also financed some joint ventures and has sought to assist and build a close relationship with national Islamic banks and national development banks. It has provided over US $ 60 m for helping the Muslim communities in non-member countries. Its total capital resources have gone up from SDR 750 m to over SDR 2 bn.[17]

In absolute term this is indeed, a highly impressive record. Yet, in the context of the wide ranging tasks assigned to it and the enormity of the resources needs of its member countries for development, this can be regarded at best as a good beginning.[18]

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17 "The Islamic Development Bank: The first ten years", Arabia (London) May 1986, pp. 66-69.

18 Bank, as reflected bythis decision to embark upon a comprehensive evaluation exercise. According to press report, he has appointed a high level panel for this purpose; see Questions for the IDB", Arabia (London) April 1986.

The Islamic Development Bank has approved a cumulative total of 579 projects valued at almost ID (Islamic Dinar) 5 bn. Financial operation can be catograized as ordinary (project financing and Technical Assistance). Foreign Trade and special Assistance Account. Technically sound and economically viable ventures are eligible for project financing". This could be in the form of a loan, interest-free loans are advanced to project of an infrastructural nature such as roads, bridge, airport and so on. They could also be those with a marked impact on socio-economic development like schools, hospitals, rural facilities and low cost housing. Technical assistance is available to conduct feasibility studies and to process project ready for financing. Equity participation is possible in capital of agricultural and industrial projects. Funds can be provided also through lines of equity granted to national development financing institution. Leasning for items such as ships, locomotives, heavy machinery and equipment is also available ownership passes on the lessee after a fixed period. Lines of leasing, facilities are also available.[19] Equity financing, untill recently had been expanding, non-availability of viable projects in the pipe-line has been cited as a reason for the present relative decline.[20]

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19 'Islamic Development Bank', FMA (Beirut) 13 November 1985.

20 "The Islamic Development Bank: The first ten years", Arabia (London) May 1986, p. 66-69.

The Islamic Development Bank introduced a method known as "Instalment rate" in which ownership of the asset is transferred to the purchase immediately after delivery while the price is payable by instalments. Financing of projects having a quick and direct returns by means of participation is known as 'profit-sharing'.

The IDB has sought to invest funds not immediately needed, in short term investment, in member countries, to finance "foreign trade", since 1977. The 'Investment Deposit Scheme' has been introduced within the framework of financing foreign trade. Deposits are accepted from government institutions and individuals with a minimum of US $ 250,000.[21]

The Islamic Development Bank has been utilising net proceeds from its deposits to provide assistance under the "special Assistance Amount". Its main objectives are:

I. Training and research aimed at guiding members to reorient their economic activities in conformity with the *shari'ah*.

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21 *Ibid*., p. 66.

II. Provision of relief to members as well as Islamic communities in non-muslim countries effected by natural disasters.

III. Financial assistance to members for the promotion of Islamic causes.

A useful medium for the transfer of technology among members has been the 'Technical Cooperation Programme". Its objectives are to mobilise technical ability of member countries by promoting cooperations and exchange of expertise, experience and information for their mutual benefit.

To foster socio-economic development among member and muslim communities world-wide, IDB has established relations with other institutions which have the same general goals. Close and active cooperation is maintained with secretariate General of the OIC, the statis s, economic and social research and training Centre for Islamic countries at Ankara, Turkey among others.[22]

The Islamic Research and Training Institute (IRTI) was established in 1983 to explore the domain of research and training in Islamic economics. The IRTI organises and coordinates research

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22 The Middle East and North Africa, (Europa Publication Limited, 1988), p.223.

for developing models and methods for the application of shari'ah in economies, finance and banking and to enable member's activities in these fields to conform. It also provides training facilities to personnel engaged in development activities.

Out of the Bank's staff of 449 (30 at inception) 432 are from member countries and 17 from Muslim communities elsewhere. The technical staff includes highly qualified economists, financial analysts, accountants, lawyers, statisticions and engineers. To a great extent, dependence is placed on IDB's own professional staff for examining and appraising projects.[23]

The developing countries face a multitude of economic hardles, chief among them are:

1. falling prices of commodities,
2. increasing protectionism of industrialized countries in the form of stiffer tariff and non-tariff barrier that adversely effect export,
4. Low level of external resources inflow,
5. violent fluctuations in exchange rate.

All of these factors are creating severe debt servicing problems for developing member countries. In addition, the effects

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23 Ibid., p. 223.

of natural disaster such as the protraced droughtin the Sahel and floods in Bangladesh contributed significantly towards constraning economic growth and development. In order to offset further deterioration and to counter the emerging dislocation the member countries have no choice but to work out practical scheme, facilities and arrangements for the generation of trade as well as diversions of their exports and imports in the direction of intra-trade and to intensify their efforts in favour of greater self-reliance and cooperation in various fields, at sub-regional and regional levels. At present, the level of intra-trade among member countries is depressingly low, inspite of the IDB's effort of the last ten years. Whereas the developed countries conduct 70 per cent of their trade among themselves, and even developing countries as a whole conduct 30 per cent of their trade among themselves for the member countries of the IDB.

In recognition of this fact, the IDB has been assigned by the OIC, and the task of setting up long-term financing facilities for promoting intra-trade through such schemes as Regional Export credit Guarantees. The dilemma faced by the IDB is that existing scheme of guaranteeing export credit were inconsistent with the shari'ah. The challenge of IDB is to device export guarantee insurance scheme in conformity with the shari'ah. The feasibility of a multilateral Islamic clearing Union is being studied by the IDB. The Islamic world awaits the results of this study because of the significance of its potential impact on furthering economic growth in member countries.[24]

Al-Rajhi Banking and Investment Corporation:

Perhaps the biggest success for Islamic banking is the recent decision of the Saudia Arabia Monetary Agency (SAMA) to give a full banking licence to the Kingdom's famed and influential money changers. Al-Rajhi company for currency change and commerce (ARCCEC).

After four years of applications, SAMA has finally agreed to allow the four Al-Rajhi brothers, Saleh, Abdullah, Sulaiman and Muhammad, to convert their money changing firm into a banking company, the Al-Rajhi Investment company. The new bank, the Kingdom's 12th, will be half-owned by the public and a share flotation. SAMA has stipulated that Al-Rajhi must shed some SR 660 million worth of real estate, building materials and agricultural investments before going public. ARCCEC has assets with SR 16.6 bn ($4.2 bn.) at present.

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24 The Islamic Development Bank: The first ten years", op. cit., p. 69.

Al-Rajhi has made it clear in its application that it will operate under Islamic banking profit-and-loss principles. Al-Rajhi has a network of over 230 branches in Saudi Arabia alone - more than both the National Commercial Bank and the Riyadh Bank, the top two in the Kingdom. Saudi banking sources predict that after one or two years of operation, the new Al-Rajhi investment company will surplus the two in terms of assets, deposits and branches. The potential for interest-free banking is vast, and depositors and investors who previously hoarded money at home would now go to Al-Rajhi. Already the Kingdom's other two Islamic banking giants, Sheikh Saleh Kamel; Al-Baraka group and prince Muhammad Al-Faisal's Dar al-Maal Al-Islami (DMI) group - both of whom have been denied full banking licences in Saudi Arabia in the past - are watching the Al-Rajhi developments keenly. A second local money changer also from the influentional Al-Rajhi family, the Jeddahbased al-Rajhi commercial establishment for currency change has applied to SAMA to change its name in advance of getting a banking licence.[25] Al-Rajhi Banking and Investment Corporation (ARABIC) is now considered as the "greatest challenge to be faced by the Saudi banking system. ARABIC is now converting from a money changer into a full service Islamic banks. This new bank has some powerful advantages over its conventional rivals. Its capital of SR 750 million is larger than the four largest banks in the kingdom combined which have only SR 680 million capital between them. It has the largest number of branches of any

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25 Recently, the Jeddah-based Al-Barakah banking group's London subsidiary, Al-Baraka International Ltd.(ABIL) has been allowed by the Bank of England to change its name to Al-baraka International Bank Ltd. (AIB) This Islamic bank is now on par with banks such as Bardays Bank and city Trust Ltd., and can engage in retail banking and issue current accounts. For the growth of its trading activities, licences have been applied for in Egypt, Nigeria, Malaysia, Pakistan, North Yemen, Kuwait and Marocco. Al-Baraka has also been developing its trading activities through its three paris-based Sabaha oil, Sabaha Textile and Sabaha Trading Companies. The group has also had talk with the Inter Arab Investment Guarantee Corporation and the Kuwait Finance House about setting up an export credit insurance company. At the end of last year, the Bahrain-based Al-Baraka Islamic Investment Bank launched its second investment fund, the Al-Ameen Company for financial securities. Earlier in 1987, Al-Baraka had set up the Al-Tawfeeq company for Investment Funds. The investment funds are seen a precursor to the establishment of an Islamic capital market and they comprise morabaha (short-term) ijara, (leasing medium term) and long-term project funds. However, there is bad news as well for the group. According to reliable Islamic banking sources, Al-Baraka is to pull out of two of its affiliates in western Europe, the Islamic International of Denmark (IBID) which is Europe's first Islamic bank, and the Islamic Finance House in luxembuorg; see the full report, "Al-Baraka expands and contracts", The Middle East, (London) March 1988, p.40.

bank in the kingdom, its balance sheet is free of any bad and doubtful debt, and it has a clearly defined-identity as the only Islamic bank in the country.[26] Arabic share issue, and its articles of incorporation, are different in several crucial respects from established practice in the kingdom. The share subscription is fully paid and available to individual and corporate investors, whereas usually such subscription in Saudi Arabia are partly-paid and available to individual investors.

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26 ARABIC has been created with many unique legal characteristics. The 16-man board of directors needs a quarum of 11 and has eight Al-Rajhis sitting on it with one of the family expected to hold the chair. The largest single share-holder is shaikh sulaiman bin Abd-al-Aziz al-Rajhi with 23.5% followed by his three brothers, Sheikh Salih (17.5%), Shaikh' Abdullah (6.5% and Sheikh Mahmud (4.5%). All four site on the board together with their sons, three of whom are listed as nominal share-holder (with 100 shares a piece). Three other family members are among the other 125 founding share-holders, each with a SR 0.3 million stake, so that the total stock held by all members of the Al-Rajhi family is SR 390.9 million, equivalent to 52.12% of the capital. The remaining founding share-holders have been carefully selected by the Al-Rajhis in order to re-inforce the Islamic identity of the bank as well as to represent the Saudi social order of the 132 name, 79 belong to the central region of the country and 33 to the west. The Eastern province is represented by 11 names, with the remaining 9 coming from the north and south of the country. The share holder's list reads like a who's who of Saudi society, including the children of prominent royal calinet ministers, as well as of the amirs of Mecca and Medina and son of the country's leading religious authority. The founder of the al-Baraka group of Islamic banks-shaikh salih' Abdullah Kamil-is included as a founding share-holder; see, MEES (London), 20 June 1988.

Dr. Muhammad Ali al-Saqqaf, Director of Research and Publications at Jeddah's National Commercial Bank, says that while 'Arabic' may not "lead" in conventional sense it is left unclear on what terms the bank can borrow. He argues that ARABIC will be able to use its own shares as a guarantee for credit facilities, that it can act as a debt-collection agency, and, within the context of '<u>murabah</u>' trade finance, can trade commodities on its own account, while the net-work of warehousing facilities envisaged by the articles makes al-Rajhi a major potential land-owner unlike other banks.

He suggests that the creation of 'ARABIC' will lead to major structural changes in Saudi banking, since it is possible that other money changers in the kingdom may wish to follow suit.[27]

In both country of our study, there exists a dual economic structure; on the one hand, there is a fairly modern urban economy with institutions and administrative infrastructure similar to those of an average capitalist economy in the West. Government regulations over the spheres of productions and transactions are generally observed. In particular, the money market is dominated by officially endarsed institutions, amongst which are the recently born Islamic financial institution.

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27 <u>MEES</u> (London), 20 June 1988.

On the other hand, like in most developing countries the rural sector of the Muslim developing countries have features which can hardly be termed as conventional economies. The production and financial institutions are outside the formal and official network, and in the absence of effective government control, there is ample room for abuse by usurers and money lenders. The most clear example of such widespread abuse exists in the village of most muslim countries eg. Pakistan, Bangladesh and Egypt etc.

Keeping in view the experiments of the Islamic financial institutions and investment companies, the question arises as to how far their performances are better than conventional banks. It is generally replied that it is a difficult task to assess their viability as these are newly established institutions. Various problems seem to be faced by these banks some of them appear to be insoluble. One problem that has not been tackled is as to how these banks will make transaction with foreign activities of Islamic banks, because they have to enter into contact with non-Islamic banks also and in this connections Islamic jurisprudence does not provide us any guidelines. As for the effects of Islamic banks an national economy are concern, it will surely depend on the nature of new financial instruments devised and the manner in which the system develops. Therefore at this stage of experiments, it is difficult to make any definite assessment of the prospects of the financial success of Islamic banks. It appears that for an adequate solutions to all these problems, Islamic financial institutions have yet go through a lot of experiments.

Having in view the performance of these Islamic banks, the success would depend on how far successfull they are in tackling in these problems. Some protagonists have come to the conclusion that for the success of these Islamic banks it is essential to change the social institutions in such a way that they become responsible to an effective transformation in social and individual economic conduct, and enhance social and economic justice. This process of institutional change, however, is by no means an easy one. Most importantly the economic conditions for the operation of entirely new institutions should exist, together with a strong will and power on the part of the government to see the proper operation of the new institutions such changes cannot simply be brought about by decree or force.

These are the challenging tasks on the implementation of which the success of Islamic banking system would be evaluated in future.

C O N C L U S I O N

The abolition of riba and the imposition of Zakah as mentioned in Qur'an and Hadith are the cornerstones of Islamic banking and financial institutions. An Islamic bank must meet two basic requirements. First, it should be based on the Islamic shari'ah, and second, it must meet all the requirements of sound banking. Feasibility of a banking operation without the rate of interest is the basic issue faced by Muslim economists. However, it is right to say that to reject the rate of interest is one thing but to deny rate of interest to others who do not subscribe to the idealogy is quite another. In a trading operation which is quite different from a loan operation, the Islamic Bank can be an active or sleeping partner into various forms of profit sharing joint-venture.

It is often claimed that Islamic banking can be more stable than the interest-based system, since in an Islamic banking system deposits are treated as shares, and any shock to a bank's asset position is immediately absorbed by a corresponding change in the value of shares held by the public in the bank which constitutes the bank's liabilities. Thus such a system has been found to be better suited to adjust to economic and financial schoks that can produce banking crisis.

From the various studies available to us, it seems that banking system based on profit and loss sharing rather than on interest, however, does not make any difference after just being branded as "Islamic". After all, the basic function of a bank is financial intermediation, and there is no prior reason to conclude that interest is the only proper instrument to do the job.

For the full application of this system, various unresolved issues may come in the practical handling of banking operations. Ingo Karsten has rightly pointed out the problems in granting short-term loan for industry and commerce as well as consumer credit. An analysis of the effects of this system on savers, banks and investors has revealed that the system's impact depends on the nature of the new financial instruments devised and the manner in which the system develops. "If this system is introduced on an optimal basis, it seems likely that the enlargement of choice will have generally beneficial consequences, particularly for savings. Furthermore, increased investment could result from the role played by Islamic banks in promotion of entrepreneuralship. A complete conversion to Islamic system, however, would require satisfactory handling of several issues that are yet unresolved, particularly those concerning the allocation and remuneration of short-term financing.

The Islamic banking is still at the stage of trial and error and that it has to compete with the highly developed western commercial banks. The achievements of many Islamic banks are quite impressive: They have been very successful in attracting funds from private depositors, and people in Muslim countries accept these new banks. After their establishment, however, these Islamic banks came in direct confrontation with already established Western commercial banks. They had thus to face, in this regard, tough competition. The experiments uptill now show that there are certain areas of employment of funds where the Islamic banks face strong competition with conventional banks, namely in the financing of trade, especially foreign trade, real estate and construction. It is still to be seen how the Islamic banks can achieve better results than the conventional banks. But the questions are generally asked, how for this concept is applicable to the contemporary economic situation ? Can it be the alternative to the modern banking system ? Will not the increased availability of risk capital be expected to lead to higher investment: Will not investment levels be expected to rise as the cost of a project entering into investor's profit calculations will be reduced and the payment for capital will be shifted from the cost to the residual income category ?

It has been argued that a large society of present day can be hardly suitable for Islamic economists' ideal economy. In a large society, members may be tempted to violate the principle on which this system rests. One writer, in this regard, thinks that Islamic economists have so far neglected this aspect, without providing a single example of a large society that has resolved this problem through religious faith, they have simply assumed that in a society of religious Muslims, everything would work smoothly. The claim that depositor's risk of productive enterprises will give a tremendous boost to economic growth, and that, the higher employment opportunities can also be expected to increase. These phenomenan'- are still to be observed. In a system based on profits and loss-sharing, it will be to the advantage of financial institutions to seek out those projects which promise the higher rate of profit. On the contrary to this some writers have also expressed the apprehensions that, replacement of interest by profit/loss sharing may make the whole economic system highly unstable as disturbances originating in one part of the economy will be transmitted to the rest of the economy. In fact Islamic banks are located or doing business mostly in the finance-rich countries and they probably have not faced real problem of raising deposits. They are individual banks working rather in insolation of the general banking system around them. The bank's operational activities are similar to those of investment companies with no or almost non-existing pure loan accounts. The strategy of these banks generally seems to be to look for project with quick return. To help to understand the effects of Islamic financial system, we investigated the efficiency of this system. We observed that while the success of Islamic bank is encouraging, they still requires greater assistances. Islamic banks need the support of government. Central bank should be more supportive in case Islamic banks are met with liquidity crisis.

Islamic banks in Saudi Arabia and Egypt during their relatively short period of experiences, have had to face two main tasks. The first being the evolution of a reasonably competent operation in the modern international banking world. Various Islamic banks have had varying degree of successes in this respect, though they may still have a long way to go to perfect their operations. The second task concerns the evolution of banking operations within an Islamic socio-economic framework. Here the need to transform the institutions towards fundamentally Islamic norms and ethics of business is very necessary. The implementation of these norms and ethics are far beyond the capacity of any one bank alone. There is a need for a comprehensive interaction of many Islamic institutions in full -fledged Islamic environment. Even if the Islamic bank is functioning on the national level, its transaction with non-Islamic banks abroad would cause problems. For of course the Islamic economy cannot be a simple closed economy.

APPENDICES

APPENDIX - I

NUMBERS OF ISLAMIC FINANCIAL INSTITUTIONS

S.No.	Institution	Country	Date of Foundation
1.	Al Baraka Bank	Sudan	1982
2.	Al Baraka Islamic Investment Bank	Bahrain	1984
3.	Al Baraka International PLSC	UK	1983
4.	Al Baraka Investment and Development Co.	Saudi Arabia	1982
5.	Al Baraka Turkish Finance House	Turkey	1984
6.	Al Rajhi Co. for currency exchange and commerce	Saudi Arabia	1978
7.	Al Rajhi co. for Islamic Investments	UK	1980
8.	Bahrain Islamic Bank	Bahrain	1979
9.	Bahrain Islamic Investment Co.	Bahrain	1981
10.	Bank Islam Malaysia	Malaysia	1983
11.	Beit Ettamouil Saudi Tousi	Tunisia	1984
12.	Dar-al-Mal-al-Islami	Switzerland	1981
13.	Dubai Islamic Bank	UAE	1975
14.	Faisal Islamic Bank of Egypt	Egypt	1977
15.	Faisal Islamic Bank of Sudan	Sudan	1977
16.	Faisal Islamic Bank of Turkey	Turkey	1985

17.	International Islamic Bank	Bangladesh	1983
18.	Islamic Bank International	Denmark	1983
19.	Islamic Banking System International Holding	Luxembourg	1978
20.	Islamic Development Bank	Saudi Arabia	1975
21.	Islamic International Bank for Investment and Development	Egypt	1981
22.	Islamic International Co. for Real Estate Development	Egypt	1981
23.	Islamic Investment Co. of the Gulf	Egypt	1982
24.	Islamic Investment House	Jordan	1981
25.	Jordan Islamic Bank for Finance and Investment	Jordan	1978
26.	Kuwait Finance House	Kuwait	1977
27.	Kuwait Finance House (Turkey)	Turkey	1983
28.	Nasser Social Bank	Egypt	1972
29.	Qatar Islamic Bank	Qatar	1983
30.	Saudi-Philippine Islamic Development Bank	Saudi Arabia	1982
31.	Tadamon Islamic Bank	Sudan	1983
32.	West Sudan Islamic Bank	Sudan	1984

Source : Arabia; Middle Eastern Financial Director, 1985; The Middle East, 1985.

APPENDIX - II

FIBE BALANCE SHEET AT THE END OF YEARS 1979, 1980, 1981, 1982, 1983 and 1984

Assets	1979	1980	1981	1982	1983	1984
Cash	1.5	2.1	166.1	137.0	179.6	234.9
Bank and correspondents	9.7	32.5	25.4	10.9	6.0	2.5
Musharaka, Mudaraba	24.1	154.9	349.3	820.5	1267.0	1520.9
Murabaha and short-term investment operations						
Long-term investment	-	-	5.1	12.9	20.0	35.5
Sundry debit accounts	0.9	2.6	10.2	7.0	16.5	48.9
Fixed assets (net)	2.5	3.6	4.1	8.2	15.1	19.2
Total.assets	38.7	195.7	560.3	996.5	1504.2	1861.9
Liabilities						
Deposits	23.6	140.1	469.1	792.6	1216.7	1531.1
Banks and correspondence	-	22.1	28.8	29.7	6.7	10.1
Creditors and sundry credit	2.2	9.7	35.9	133.4	226.2	259.8
Accounts						
Zakat Fund	0.1	0.3	0.3	0.2	0.1	0.4
Provision for Musharaka operation risk	-	0.2	0.6	0.9	2.9	6.6
Provision for employees retirement	-	-	- -	-	0.2	0.5
Equity						
Capital						
Paid-up capital	10.0	19.0	19.7	29.6	38.0	40.0
Capital instalment paid in advance	1.8	0.7	1.5	0.3	-	-
Reserves						
General reserve	-	0.1	0.5	1.0	1.5	2.4
Special reserve	-	-	-	3.1	3.1	3.1
Net distributable profit (after distributions to investment accounts	1.0	3.5	3.8	5.7	8.8	7.9
Total	38.7	195.7	560.3	996.5	1504.2	1861.9

Source : The Islamic Business Enterprise (1987)

APPENDIX - III

ZAKAT FUND REVENUE AND EXPENDITURE OF FIBE

Revenues	1983 £.E.000	1984 £.E.000
Balance from previous years	207	120
Previous allotment	-	175
Zakat due on the bank's operations	235	364
Zakat from individuals	103	107
Donations	45	21
Return on investment of deposits in the fund's name	-	13
Total	865	1168

Expenses	1983 £.E.000	1984 £.E.000
Zakat to individuals	202	339
Zakat to needy students	460	411
Zakat to mosques	14	46
Charitable organisations	3	87
Clothes	29	56
Zakat due to individuals (not yet paid)	65	45
Private donations transferred to investment	37	-
Surplus	55	77
Total	865	1168

Source : The Islamic Business Enterprise (1987)

APPENDIX - IV

IBID BALANCE SHEET AT THE END OF THE YEAR 1981, 1982, 1983 and 1984

				$m
Assets	1981	1982	1983	1984
Cash	0.1	4.1	40.4	31.4
Banks and correspondence and investment accounts in Islamic Banks	3.3	28.0	148.5	89.9
Musharaka, Mudaraba, Murabaha and short-term investment Operations	6.8	46.1	184.6	487.8
Long-term investments	-	0.5	1.6	2.4
Debtors and sundry debit accounts	1.9	4.2	27.9	57.9
Fixed assets (net)	2.5	6.5	9.3	11.2
	14.6	89.4	412.3	680.6

Source : The Islamic Business Enterprise (1987)

APPENDIX - V

IBID OPERATIONS IN 1984

Items	Balance of implemented operations $m	Balance of operations under completion $m	$m	Total %
Musharaka	33.1	67.2	100.3	20.6
Murabaha	164.9	8.0	172.9	35.5
Mudaraba	7.5	11.8	19.3	4.0
Selling at commission	-	1.2	1.2	0.2
Direct Trading	1.6	10.6	12.2	2.5
Finance with declining participation	-	13.4	13.4	2.7
Real estate	33.5	59.5	93.0	19.1
Merchandise investments	-	72.2	72.2	14.8
Agencies	240.6	247.2	487.8	100
Liabilities				
Deposits	7.8	74.0	307.6	502.9
Banks and correspondence	1.2	-	23.1	29.1
Creditors and sundry credit, accounts provisions	0.2	7.7	69.5	132.4
Profit allocated for distribution	0.3	1.5	2.4	3.0
Zakat Fund	0.1	0.1	0.1	0.1
	9.6	83.3	402.7	667.5

Shareholders' equity capital				
Paid capital	4.8	5.7	8.6	11.4
Statutory reserve	0.1	0.2	0.5	0.8
General reserve	-	-	0.4	0.8
Profit carried forward	0.1	0.2	0.1	0.1
Total	5.0	6.1	9.6	13.1

Source : <u>The Islamic Business Enterprise</u> (1987)

APPENDIX - VI

I - ISLAMIC DEVELOPMENT BANK OPERATIONS

Country	Project A - LOANS	Cost $ million	I.D.B. (I.D.)	Participation $	Period years
Cameroon	Songloulou hydroelectric plant	230.00	6,000,000	7,000,000	25
Bangladesh	Dacca International Airport	73.77	6,087,000	7,000,000	30
Somalia	Hargeisa-Borama road	30.00	6,500,000	7,500,000	30
Sudan	Nyala-Kas-Zalingie road	105.45	4,500,000	5,000,000	30
Sudan	Supply of laboratory equipment	7.38	3,000,000	3,500,000	21
Niger	Birni N'Konni irrigation scheme	14.00	4,890,000	5,600,000	30
Tunisia	Sfax fishing port	29.90	6,087,000	7,000,000	30
Egypt	Suez Canal expansion project	1136.00	10,300,000	12,000,000	18
South Yemen	Institute of Marine Resources and Marine Sciences	3.60	1,739,130	2,000,000	30
Algeria	Jigel port	342.40	6,360,000	7,500,000	20
Senegal	Cap-Skirring-Ziguinchor road	18.76	5,300,000	6,250,000	25

Mauritania	Expansion of teacher's college	0.83	645,762	762,000	30
	Sub-Total				
	B- EQUITY PARTICIPATION				
Jordan	Petroleum refinery	189.22	7,450,000	9,300,000	
Sudan	Cotton textile mill	37.50	2,150,000	2,500,000	
Pakistan	National Petroleum refinery	63.73	3,510,000	4,040,000	
Guinea	Clinker grinding plant	15.60	4,070,000	4,680,000	

Source : Arab Banking File, 1984

APPENDIX - VI

ISLAMIC DEVELOPMENT BANK

Malaysia	Pahang cement plant	58.00	5,800,000	6,700,000	
Pakistan	Lawrencepur woollen and textile mills	5.30	2,000,000	2,340,000	
Cameroon	Cellucam paper mill plant	232.00	7,000,000	8,333,000	
Morocco	Oriental cement plant	182,00	8,700,000	10,000,000	
Malaysia	Malaysian Development Bank	-	5,000,000	5,750,000	
	Sub-total	-	43,608,000	50,519,960	
	C-FOREIGN TRADE FINANCING				
Algeria	Purchase of coke and copper wire		10,925,000	12,570,000	16.2.77
Turkey	Purchase of coke		8,700,000	10,000,000	5.6.77
Pakistan	Purchase of fertilizers		13,040,000	15,000,000	9.8.77
Sudan	Purchase of refined petroleum products		2,801,000	3,249,960	21.9.77
Turkey	Purchase of fuel oil		8,142,000	9,600,000	6.12.77
	Sub-total		43,608,000	50,519,960	
	D - LEASING				
Bangladesh	Cargo vessel for Bangladesh Shipping Corp.		6,005,220,000	6,000,000	6.12.77

Source : Arab Banking File (1984)

APPENDIX - VII

PRINCIPAL OPERATION OF ISLAMIC DEVELOPMENT BANK

Hegirian year in ID Million	1396	1397	1398	1399	1400	1401	1402	1403	1404	1405	Total	%	Oper. No.
Loans	6.0	55.4	25.5	33.7	52.7	28.1	48.1	73.5	71.5	98.6	493.0	10.0	85
Equity	7.5	38.2	29.4	39.8	39.0	46.0	28.7	15.6	6.0	9.9	260.0	5.4	60
Leasing	-	5.2	10.0	16.3	36.5	30.7	73.5	86.4	125.3	92.1	462.0	9.5	50
Install, sale	-	-	-	-	-	-	-	-	-	65.9	65.9	1.4	7
Profit sharing	-	-	4.3	-	-	-	-	3.1	-	-	7.3	0.2	2
Tech. assis	-	0.8	0.8	1.4	3.4	6.8	4.4	6.0	3.0	6.6	33.3	0.7	64
Foreign trade fin	-	43.6	127.4	262.5	352.7	370.2	359.8	480.6	714.3	668.2	3379.3	69.5	250
Special assist. acct.	-	-	-	0.7	8.5	5.3	9.3	7.8	62.6	63.9	158.2	3.3	57
Total	13.5	143.3	197.4	354.3	492.7	487.2	523.7	673.0	982.7	1005.2	4859.0	100	575

Source : Arab Banking File (1984)

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